

103

MID-SESSION REVIEW OF THE ECONOMIC AND BUDGET OUTLOOK

Y 4. B 85/3:103-11

Mid-Session Review of the Economic...

HEARING BEFORE THE COMMITTEE ON THE BUDGET HOUSE OF REPRESENTATIVES ONE HUNDRED THIRD CONGRESS FIRST SESSION

HEARING HELD IN WASHINGTON, DC, SEPTEMBER 14, 1993

Serial No. 103-11

Printed for the use of the Committee on the Budget



DEC 13 1993

U.S. GOVERNMENT PRINTING OFFICE
WASHINGTON : 1993

72-289 CC

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402

ISBN 0-16-041711-2

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MID-SESSION REVIEW OF THE ECONOMIC AND BUDGET OUTLOOK

TUESDAY, SEPTEMBER 14, 1993

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10 a.m., Room 210, Cannon House Office Building, Hon. Martin Olav Sabo, Chairman, presiding.

Members present: Representatives Sabo, Kildee, Berman, Stenholm, Slaughter, Parker, Gordon, Price, Costello, Johnston, Mink, Orton, Pomeroy, Browder, Woolsey, Kasich, Shays, Snowe, Herger, Bunning, Smith of Texas, Allard, Miller, Lazio, Franks, Smith of Michigan, and Inglis.

Chairman SABO. Good morning. The House Committee on the Budget is in session for the purpose of a hearing on mid-session reviews of the economic and budget outlook.

Within the past 2 weeks, both the administration and CBO have submitted their updates on the economic and budget outlook. This morning we will hear from our former Chairman, the Director of the Office of Management and Budget, Leon Panetta. He will be followed later this morning by Dr. Robert Reischauer, the Director of the Congressional Budget Office.

I want to alert the committee members that our witnesses each will be here for about an hour, so try and keep questions precise and to the point. We will try and adjust, if we don't get to members with Leon; and we will try and give priority for those who are here for Dr. Reischauer.

Let me make a couple of observations before we start, as we have these two reports, and while there are some differences between them, I think they are really marked by their similarity. I have a couple of charts to my right. One shows the varying projections as they relate to the Federal budget deficit as a percentage of the gross domestic product. The top red line shows the March projections. The solid green line is the CBO projections through 1998. The dotted green line is the projections by OMB through 1998.

As always, you see some variations, with CBO projecting somewhat lower deficits in the first couple of years than OMB, and then CBO projecting somewhat higher numbers in 1996, 1997, 1998. But the similarity between the two projections for the future is remarkable.

The chart on the right shows the impact on the Federal debt as a percentage of gross domestic product. That shows the CBO projection for the future in comparison to their earlier CBO estimate,

again showing a significant drop in the out years, from the impact of what we did this year.

So I think the story is that while we had quarrels over how to do it, the fact is the Congress did pass serious deficit reduction in the reconciliation package in August. It clearly has significant impact on reducing the projected deficits for the future.

Mr. Director, we are here today to thank you for your leadership in this effort. It was not simple or easy. But it passed and I think the country is better off because of that.

Mr. Kasich?

Mr. KASICH. Thank you, Mr. Chairman.

I want to welcome Mr. Panetta here this morning. I do want to compliment the administration on its program to reinvent government. I have told our leadership that I think the Vice President has done a good job on it. It, of course, will be a matter of whether you want to push it through, both by including it in your budget document next year and whether you are willing to shake up the bureaucracy and take on the Chairmen you are going to face up here. I don't mean the Chairman necessarily, but also the Vice Chairman, the congressional status quo crowd. But it has been a good first cut and I am really happy about it.

In terms of the mid-session review, I would point out that the 1990 Budget Act projected a balanced budget by 1998, so these projections are all, of course, just a matter of just that, projections into the future.

I don't want to make a comment having as much to do with the deficit as with the thing that concerns all of us. We had a former Governor, Mr. Panetta, by the name of Jim Rhodes, who said there are only three things that matter to politicians and the people: Jobs, jobs, jobs. With a 2 percent growth, which is not enough to create more new jobs and absorb people into a growing economy, we have a job crisis, in my judgment. It is better than negative growth, but 2 percent growth is just not enough.

I know the administration feels if you had gotten the stimulus package, the numbers would be up. The Republicans don't happen to subscribe to that. The issue is, what do we do to get Americans working?

We tend to feel we ought to protect people's investments against inflation, have regulatory changes, tax incentives for business to hire more people for increased productivity. I think the debate over the next year is going to be our philosophies as to how we are going to get the economy moving and get Americans employed.

And I would hope that as we go into the next budget cycle, we concentrate on reinventing government. We are going to want to reinvent it probably more boldly than you. At the same time we think it is vital that we get the economy moving again with private sector incentives, and we get Americans working. That is what I am concerned about in this mid-session review.

Next year's projections show 3 percent growth. That again is a projection. It has been brought down from where you originally were. This 2 percent growth is just not acceptable. Next year's projections are just that, projections. The reality of today, though, is that Americans who are unemployed are likely to remain unem-

ployed, and our greatest efforts right now should be directed in terms of getting these people back to work.

And I look forward to working with you, Mr. Panetta. I am very interested in what kind of rescission list also you will be sending up here, when, and what kind of numbers we are talking about.

Thank you, Mr. Chairman.

Chairman SABO. Thank you.

Mr. Panetta.

STATEMENT OF HON. LEON E. PANETTA, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. PANETTA. Thank you very much, Mr. Chairman, members of this committee. It is always good to be back in the Budget Committee. There are moments when I yearn for the Budget Committee, in the work that I am doing as Director of OMB.

We face a common challenge. Together we have got to work on that challenge. There are a number of problems that face our society and that face our economy. And it is pretty clear we cannot even begin to deal with these problems unless we all work together to face what are some very serious issues that confront all of us.

Mr. Chairman, what I would like to do is to submit my statement for the record, and to summarize as briefly as I can the key points in the mid-session review and allow as much time for questions as possible, if that is okay.

Chairman SABO. No objection. The entire statement will be put in the record.

Mr. PANETTA. The purpose of the mid-session review, as most members of this committee know, is to update our economic forecast, both in the short run and the long run; to present the new budget projections based on revised assumptions; and to try to present that to you and to the country so that we all have some sense of where we are and how the future looks.

Let me summarize the key points in the mid-session review. First of all, with regards the deficit, this was a driving element of the entire economic plan, to focus on the need for deficit reduction. We are running a \$4 trillion debt, we are running annual deficits exceeding \$300 billion as far as the eye could see. It was extremely important for this country to confront the need to control the deficit.

We think we are on track with the package that was adopted in terms of dealing with the deficit. There is obviously a lot more that needs to be done, and I will mention those points. But the package itself contains the elements that all of us debated.

Those are the key elements that are on that chart: \$71 billion in entitlement cuts, a good portion of that, almost \$56 billion, in medicare savings, about \$7 billion in medicaid savings, as well as agriculture and veterans savings. The discretionary caps of \$108 billion represent a hard freeze with regards to discretionary spending for the next 5 years.

I would just indicate to you we have already begun alerting agencies and departments that they are going to have to meet some very tough goals for fiscal 1995. For those that are concerned about whether or not we are going to face some tough choices, there will be some tough choices both in the administration and the Congress

in the appropriations process, because you cannot meet these targets we have established for 1995 without making some very difficult choices.

We have indicated to the departments, as a matter of fact, that if you were to fund the investments that the President cares about, you are looking at almost a 10 percent reduction in each of the departments and agencies. So that is a real tough challenge in terms of reordering priorities, and clearly the Congress will have to face that as you deal with the appropriations measures.

The debt service is \$76 billion, which gets you to \$255 billion, and the revenue portion is \$250 billion. So we estimate at OMB that we are looking at a total of about \$505 billion in deficit reduction over these next 5 years.

That gets us to a deficit target that we were aiming at, which is to try to cut the deficit to GDP ratio in half. And this plan takes us from a deficit ratio of about 4.6 percent and brings it down to less than half, to 2.2 percent in fiscal year 1998. That is a deficit then of roughly \$181 billion as opposed to a projected deficit that was somewhere around \$387 billion for 1998. So we have cut that ratio beyond one-half, which was the target.

And, interestingly enough, what we are beginning to see is instead of \$300 to \$400 billion deficits over the next 5 years and beyond, we are beginning to force those deficits down to somewhere between \$180 to \$200 billion. They are below \$300 billion, which is a significant achievement, based, again, on the challenges out there.

Again, we have to do more. But I think we are looking at the beginning of an effort to stabilize that debt to GDP ratio. If we can accomplish that, we think it is significant in terms of the economic future, and the future, really, of this country as well.

Let me just point out on the next chart where we see the deficit going. It is similar to the chart that the Chairman has prepared. If we had not enacted the economic plan and just stuck to existing policy, that would be the upper red line that would have taken us, as I said, deficits somewhere around \$380 to \$400 billion at the end of that period. The deficit reduction package plus economic and other adjustments that have been made as part of the mid-session review show the line taking us to \$181 billion.

If you look beyond that, incidentally, initially we had seen a line that goes dramatically back up again largely because of health care costs. Interestingly enough, our projections now indicate that line is stabilizing a little more. It rises, but it doesn't rise at quite the rate that we had earlier in the year, which is an indication that at least in the health care area, there has been a slowing down of the kind of cost increases that we have seen over the last few years. Nevertheless, if we don't do something on health care costs, those are continuing to increase at almost 10 percent a year, and that will continue to drive the deficit back up if we don't deal with it.

But we have taken a major first step here in trying to drive that deficit down. And it is very important that we keep that line headed in a downward direction.

But as a result of the mid-session review, and it is confirmed by CBO, we have taken a major step towards trying to control the def-

icit. And that is an important step that all of us need to continue to focus on for the sake of our people.

On the deficit outlook, one of the questions that was asked is the differences between the 1990 agreement and the one we have just put into place. Obviously there are some similarities, particularly in the tools that are part of the agreement that was just passed, the economic plan. And they are important tools.

I have always felt—and I know there has been some dispute over this—but I have always felt the tools that were part of the 1990 agreement have worked effectively. The Congress has adhered to caps that have been established on discretionary spending. The Congress has refused to do anything to exceed those caps. We have had some emergencies, but those were legitimate emergencies, particularly on natural disasters. But beyond that, we have not breached the caps that were established in the 1990 agreement.

In addition to that, the pay-go rule, which is also part of the 1990 agreement and is part of this agreement, has really had a significant impact in terms of the creation of new entitlements. We have made very clear that if new entitlements are to be created or any action is to be taken by the Congress, either on tax cuts or anything else that would add to the deficit, that that has to be made up, and we need to know how that is going to be paid for.

That has been a tremendous discipline in terms of controlling the expansion of entitlement programs. And I think that is an important step in the right direction as well.

The main problems we saw in the 1990 agreement, and the failure to meet the promise that was held out in the 1990 agreement, really was in two main areas. One was a recession that began almost 6 months before the provisions of the budget agreement took effect. In addition, it was exacerbated by the Iraqi invasion, which also had an impact on our economy. Those two events, overall, both the recession plus the reaction to the Persian Gulf situation, impacted on the economy, reduced revenues, and obviously hurt us in the direction that the 1990 agreement set for the economy.

The second area was, frankly, that agreement did not do enough with regards to controlling entitlements, particularly in the health care area. Health care costs went up dramatically, particularly in medicaid, as a result of the recession in part; in part as a result of just the pressures on the health care system overall, and that also added to the costs and to the increase in entitlements that took place over that period of time.

The third thing is that the overall assumptions that were used in the 1990 agreement, everyone recognizes, were overly optimistic. We have tried to correct each of those areas in the economic plan that was put into place.

First of all, the assumptions we have used are conservative assumptions. They are not overly optimistic if you look at CBO's estimate on where the economy is going. If you look at the Blue Chip analysis of where the economy is going, we are all pretty much in the same ball park in terms of growth, inflation, and interest rates.

So we are not using optimistic assumptions about where the economy is going. We are using the most conservative assumptions. As a result, we feel much more confident about our ability to achieve these goals.

In addition, we think that the proposals that have been enacted here are real. We are going to achieve these savings, discretionary savings as well as entitlement savings, and the revenues are going to be achieved as well.

All of this means we will achieve the goals contained in the economic plan. There are no smoke and mirrors here. This is an effort to achieve real goals with real policies that will help us.

Having said all of that, I have to indicate that a lot depends, when you are seeking these goals, on the general performance of the economy. Our greatest concern right now, to be truthful, is the situation not so much here in the United States but in other countries. We depend a great deal on our export markets, and right now the European nations are having severe economic problems. Japan is in a recession. And our concern deals more with what may happen in those countries and our loss of markets in those countries as opposed to some of the policies that we are putting in place. Other countries now recognize that the United States has exercised some real leadership here in trying to correct the economic situation and challenges that face us.

Lastly, with regards to the general economic outlook, our forecast has not changed that much from April, because we were basing our April projections based on the passage of the economic plan that happened in August, and therefore the forecast doesn't reflect that many changes from where we thought we were in April.

There is, to be sure, an analysis that showed slower growth this year. We think part of that was just transfers from the first quarter of this year to the fourth quarter of last year. In addition to that, from the election, there was some degree of consumer confidence that built up, and some concern then based on both the actions in the stimulus bill plus the debate that took place in the economic plan that put a lot of things on hold. All of that had an impact.

Nevertheless, we are looking at about 3 percent growth for the remainder of this year, and that looks like it is pretty much on track. We are looking at slow growth but also stable growth. The two important things are the long-range outlook on inflation as well as interest rates.

The interest rate outlook continues to remain low for the out years. As a matter of fact, we have said it would be about 5.9 percent on 10-year T-bills. That rate is now at about 5.2 percent, so, if anything, we are probably being cautious about where interest rates are going in the out years. But everyone we have talked to and all of the economists we have talked to indicate that clearly there is a projection for low interest rates into the out years.

And that I think will help support what we want, which is a solid, non-inflationary growth, a solid non-inflationary recovery. We at least have put the basic elements for that in place.

Having said that, what are the major things we have got to focus on at this time?

Number one, as I have mentioned, we have got to focus on the 1995 budget. That is an internal operation with regards to the administration. But I would share with you that to implement a hard freeze on discretionary spending, as well as the other goals in the

economic plan, is going to be tough to do and we are now in the process of doing that.

We have asked agencies and departments to report their budgets back to us by October 1. We expect that we are going to be in a long series of discussions with Cabinet Secretaries, departments and agencies as we battle over priorities within that budget.

But the 1995 budget submission will be without question an implementation of the economic plan. We intend to stand by the targets that were in the economic plan, and we hope to, within those targets, establish the priorities that we care about.

Secondly, reinventing government is without question a major step as well, because it aims at the need to restore the trust of people in government. No matter what we do, no matter what any President tries to do on economic policy, on tax policy, on jobs policies, on policies relating to education, on policies related to trade or anything else, you cannot effectively implement those kinds of policies unless we restore the fundamental trust of people in government itself and the fact that we can do our job. That is not there right now.

The Vice President has recognized that. The President has recognized that. We have got to do a major job in restoring trust. That isn't just a simple question of saying it; you have got to do it.

The report that was issued by the Vice President's task force is a major step in looking at almost every area in which action is necessary to restore trust of people in government. We intend to implement that report. We have already taken action on Executive Orders to implement pieces of that.

Just over the weekend the President issued an Executive Order that mandates every department and agency to cut their internal regulations in half, which needs to be done. We have personnel policies, all kinds of memos within departments and agencies, that are clogging the system. That can be cut back. An order has been issued to that effect.

Secondly, we have asked each agency and department to submit plans by December 1 to tell us how they will achieve the reduction in personnel. We are looking at Federal employees being reduced 252,000 over a 5-year period. We are already on track to reduce 100,000 Federal employees by 1995. There will be an additional 152,000, those positions will be eliminated over a 5-year period.

That is not going to be easy to do. But that is based on the policies within reinventing government. If we can simplify the procurement policies in government, if we can deal with some of the personnel policies to give greater flexibility to personnel within the government, and if we can implement some other approaches that were contained in the report, we think we can achieve that goal, in part by attrition, but in part through just simply not needing those positions that are there right now.

On reinventing government, we are going to do Executive Orders, we are going to do directives, and do as much as we can within the administration to implement some of those pieces.

Secondly, in October, we intend to submit to the Congress a package of rescissions based on the appropriations bills that hopefully will have been enacted by that time. We will present a set of rescissions. In addition to that, we will present recommendations

out of the reinventing government report that will implement some of the key provisions of that report as well.

And our intention is to present this as a single bill to the Congress, and hopefully the leadership will expedite consideration of that legislation and also the opportunity for members to submit amendments to that as well. But our goal is to submit in October a spending cut proposal that will be combined with rescissions as well as elements of the reinventing government.

The third step is to take the remaining provisions of this and build it into the 1995 budget process. There are some tough provisions, as you know, that are part of the recommendations. We think that a lot of that can be incorporated in the budget process for 1995 as well.

So those are the steps that we intend to take for reinventing government. We would ask for your cooperation and help. We think this truly can be a bipartisan effort in achieving the goals that are part of that report.

The last point I would make is we have got health care reform. The importance of health care reform is to deal with the problem that I just talked about. If we are going to control those out-year costs, we have got to do health care reform.

I know there will be a major debate, and there should be a major debate in this country over something as significant as health care reform. Everyone has different views and ideas about how we do it. But the bottom line is, we have got to do it. We have got to control health care costs in the out years. If we don't, we will not control the out-year deficit outlook. And we will not turn those resources to needed areas. We will be constantly searching for the resources that we need to do the job. We can't afford to do that as a leading country in the world.

Yesterday's ceremony was perhaps one of the most moving ceremonies I have ever been a part of, either as a Member of Congress or as a member of this administration. But the basic point that came from that ceremony is that the United States provides leadership in the world. That is our role. Whether it is trade or trying to work for peaceful solutions like that or whether it is economic leadership, we are looked to as leaders in the world. We have a responsibility to deal with problems facing our society.

We are looking at a full agenda. I am the first one to know that because I am the one that has to deal with many of these issues within OMB. But we cannot as a country turn away from these problems and these challenges. They are not going to go away. They are not going to solve themselves. We have got to roll up our sleeves and get to work.

If there is any message that the American people are sending to both the Congress and the President, it is, "Do the job, get to work, solve these problems." We may have differences as to how we do that. But let us all commit ourselves to facing these challenges. Because I think the fundamental principle that pulls all of these things together—whether it is the economy, whether it is the economic plan, whether it is deficit reduction, whether it is trade, whether it is health reform—is the fact that we are trying to provide our kids with a better life. That is the American dream. And we have lost that dream over the last few years.

Our responsibility is to restore that dream, and we can't do it unless we take on these challenges.

Thank you, Mr. Chairman.

[The prepared statement of Hon. Leon E. Panetta follows:]

PREPARED STATEMENT OF HON. LEON E. PANETTA, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

I am pleased to report to you on the state of the economy and the budget at mid-year. As you know, the Administration chose to release its *Mid-Session Review* after the completion of the reconciliation process in early August. I trust that you will agree, with the wisdom of hindsight, that this choice has resulted in a far more useful document for the Administration, the Congress, and the public alike.

The *Mid-Session Review* is a progress report on the Administration's economic revitalization program. It reviews the strategy behind the economic plan submitted in February and describes the changes that have been made as the Administration and the Congress worked together to turn the plan into legislation. It presents the Administration's latest economic forecast for both the short run and the long run, updates the economic assumptions underlying the plan, and presents new budget projections based on the revised assumptions. My testimony today will summarize the outlook for the economy and the budget under the new economic program.

SUMMARY

Effects of OBRA-93 on the Deficit

The President's goals for deficit reduction have been achieved. The reconciliation bill enacted last month provides \$504.8 billion in deficit reduction over 5 years. The deficit will fall below \$200 billion in 1996, and will remain below \$200 billion through the remainder of the projection period. More than half of the deficit reduction comes from spending cuts—and the margin of spending cuts over tax increases will grow over time.

The 1994 deficit, which was estimated in April at \$305.3 billion, is now estimated to be \$259.4 billion. This is about 4.0 percent of GDP, instead of the 4.7 percent originally forecast. The President's deficit reduction package accounts for the full decline of \$45.9 billion; other influences, including legislation and technical reestimates, cancel each other out.

The 1998 deficit is now estimated to be \$181.0 billion, \$206.7 billion less than the April estimate of \$387.7 billion. Of this change, \$145.8 billion comes from the President's deficit-reduction program, and \$54.4 billion comes from changes in the economic forecast—leaving just \$6.7 billion for all other factors. As a percentage of GDP, the deficit is cut by more than half in 5 years—from 4.6 percent in fiscal year 1993 to 2.2 percent in fiscal year 1998. We estimate that the structural deficit will be cut almost in half—from not quite 4 percent in fiscal year 1993 to about 2 percent in fiscal year 1998.

Under the Administration's projections, by the end of the 5-year budget window, the ratio of the Nation's public debt to its gross domestic product will be stabilized. Since 1981, the debt has grown faster than the economy, with the ratio of the debt held by the public to the GDP increasing from 26.5 percent in 1981 to 51.1 percent in 1992. We estimate that the enactment of the President's economic plan and an improved economic performance will halt the growth of the debt to GDP ratio at 53.2 percent in 1994, and pull it down slightly to 52.9 percent in 1996 through 1998.

Contingencies in the Deficit Outlook

Some critics have argued that the current plan cannot succeed because the 1990 budget agreement failed. This criticism is wrong on two counts. First, the 1990 budget agreement did restrain Federal spending. It imposed caps on discretionary spending, which both the Congress and the Executive branch obeyed. (The "emergency" clause in the Budget Act, cited by some as a major loophole, sanctioned a total of \$8 billion in spending over the past three fiscal years—for such obvious disasters as Hurricane Andrew—or only about 1 percent of the deficits over those years.) The agreement also restrained new entitlement spending and tax cuts through a "pay-as-you-go" process, which also has been observed. Thus, the 1990 budget agreement in fact held spending down.

Second, the deficit increased over the projections of the 1990 budget accord for two reasons that do not apply now: because the economy slid into a recession (which began 6 months before the provisions of the budget agreement took effect and was exacerbated by the subsequent Iraqi invasion of Kuwait, which also preceded the

budget agreement); and because pre-existing health care programs have grown more rapidly than was anticipated at the time. Today's situation is different on both of these scores. First, the economic projections underlying the President's budget program are far more cautious than the rosy assumptions used in 1990; they anticipate growth very close to the consensus of private forecasters, and they assume interest rates higher than we observe today. And second, we have learned more about entitlement behavior since 1990, and the projections today are more cautious on that front as well. In fact, this Mid-Session Review reestimated entitlement costs downward, because actual data since the beginning of this year show that the budget's projections were too high. Further, the President's program includes substantial cuts in the important medical care entitlements, affecting the very features of the health care system that have added to costs since 1990; and the Administration is preparing a comprehensive health care reform for release later this month.

No one can guarantee the future, and there are contingencies that could push us off of the path that we have drawn in our economic and budget review. However, on the basis of our experience since 1991 and with the budget process improvements enacted in reconciliation—especially those relating to entitlements in general, and medical care costs in particular—there is every reason to believe that the President's plan will bring the deficit down. It is noteworthy that the behavior of the financial markets endorses this view.

I must emphasize, however, that the enactment of the economic program was only the first step in getting the deficit under control.

Under the economic plan, most components of the spending side of the budget will merely keep pace with the growth of the economy, and discretionary spending will be frozen in dollar terms over 5 years. However, Federal spending for the health care programs—medicare and medicaid—is projected to grow at a rate of more than 10 percent per year. Those programs grow so fast and have already become so large that the deficit cannot be contained without systemic reform of our health care system. The Administration will announce such an initiative later this month.

The Economic Outlook

The Administration's economic forecast at mid-year is largely the same as what we released in our *Budget* in April. At that time, as is customary, we projected the major economic variables in anticipation of the enactment of the President's program. The President's program is now in law. Accordingly, with one notable exception, we see little change in the prospects for the economy in years to come from what we anticipated 5 months ago.

The economic outlook is promising. To be sure, economic growth in the first half of this year was less than most forecasters expected; but the reconciliation bill has helped to lay the foundation for solid and sustainable economic growth in the years ahead. The economy has begun to create jobs. Inflation remains firmly under control. And perhaps most surprisingly, interest rates have declined beyond the expectations of virtually all economic forecasters—facilitating investment for long-term income and job growth. That change is probably the principal reward of passage of the President's economic program.

While the Administration's economic forecast is little changed from our own projections at the release of the *Budget*, our current forecast is somewhat different from the CBO outlook that was used for the budget resolution. Our current real growth projections are somewhat less sanguine in the near term, but see a higher long-term sustainable rate of economic growth. We are somewhat less optimistic about inflation, in keeping with the private-sector consensus. Our unemployment projections are slightly lower. Finally, in keeping with recent experience, we see lower interest rates, particularly long-term interest rates, throughout the forecast period. Overall, these changes in economic assumptions reduce the deficit somewhat—but largely on the ground of lower interest rates, which are now established fact.

MID-SESSION REVIEW OF THE 1994 BUDGET

The Economic Outlook

You will recall that the Administration used the Congressional Budget Office (CBO) economic assumptions for purposes of the budget submission in April. We believed that we could focus the budget debate on the issues, rather than diverting attention to the economic assumptions, by adopting the same forecast as the Congress. At the same time, however, we released our own economic forecast, and calculated the budget deficits that would result under those assumptions. We no longer had the option of using CBO economic assumptions for our *Mid-Session Review*, because CBO's update of those assumptions was not yet available. We also believed

that it was important to reflect the economic effects of the enactment of the President's plan. Therefore, we reverted to the Administration's own economic forecast.

The Administration's economic forecast at mid-year is largely the same as what we released in our *Budget* in April. At that time, as is customary, we projected the major economic variables in anticipation of the enactment of the President's program. The President's program is now in law. Accordingly, with one notable exception, we see little change in the prospects for the economy in years to come from what we anticipated 5 months ago.

However, 5 months have passed since the release of our *Budget*, and so our economic forecast does incorporate recent developments. The news from the economy over the past 5 months has been mixed. However, the Administration believes that the legislative action of the last 5 months has laid the foundation for steady and sure progress in the future.

Economic growth. Like most other economic forecasters inside and outside of government, the Administration believes that recovery from the 1990-91 recession is far from complete, and that the economy has room to grow before it reaches its productive capacity. The open questions are how fast the economy will approach full utilization of its capacity, and how fast it can continue to grow thereafter.

The Administration's growth forecast for the second half of 1993 through the end of 1998 is essentially unchanged from the April *Budget*. We foresee the economy growing at a 3 percent annual rate in the coming months, with growth gradually tapering down to a 2.5 percent sustainable growth rate in 1998, when the economy reaches its productive capacity. This is a cautious, credible forecast. It is quite close to the consensus of private sector forecasters published in the *Blue Chip* survey.

We have altered our estimates for the first half of this year, however, to account for the additional information that is available now. The economy grew more slowly than we anticipated in the beginning of this year, in part because the rapid growth at the end of last year was in effect borrowed from this year, in part because of other temporary factors, and in part for other reasons that no one can identify with certainty. The lower rate of growth for the first half of this year, even with no change in the forecast for the second half, reduces the projected growth for the year as a whole; the Administration has in fact lowered its estimate to below those of the Congressional Budget Office (CBO) and the *Blue Chip* consensus.

The economy has notable sources of strength. Employment has begun to grow this year, signaling the end of the "jobless recovery," that job growth is needed to make this recovery self-sustaining. Inventory accumulation has been moderate, and so increases in consumer demand in the near term will stimulate additional production; that production will generate income and jobs. There is pent-up demand for housing and automobiles, and lower interest rates will help to unleash that demand. U.S. industry has streamlined itself, to become the low-cost producer in high-tech markets around the world; our cost of capital to businesses is at its lowest level in decades, and the dollar is at a competitive level. In part because of the potential in export markets, businesses are investing in productivity-enhancing equipment at a healthy clip.

There are downside risks. The economies of most other industrialized countries are very weak. Despite our strong export potential—and already healthy exports to the developing and newly industrialized countries—our exports will be constrained by the weak demand of many of our trading partners. Further, the economy still suffers from the legacy of the 1980s—including the accumulation of debt by households, businesses, and all levels of government, and the overbuilding of real estate—not to mention the welcome but painful economic adjustment to the end of the Cold War. No one really knows how long it will take for these adjustments to be completed, and for a more historically normal functioning of the economy to resume. Still, we believe that the passage of the Clinton plan lays the groundwork for a more solid economic expansion.

Unemployment. In keeping with the Administration's projection of steady, moderate growth in the months ahead, we anticipate an equally steady and measured reduction in unemployment. By 1998, the unemployment rate should have virtually reattained its lowest levels of the 1980s. The length of time needed to restore that low level of unemployment is just one indication of the costs of the 1990-91 recession, which was an inevitable adjustment to the excesses and imbalances of the 1980s—themselves largely caused by mistakes in economic policy. However, if the economy follows the path that we project, the low level of unemployment in 1998 will be far more sustainable and secure than the same level in the late 1980s.

Inflation. An upward blip in measured inflation in the first quarter of this year caused significant concerns. The Administration has in fact increased its inflation forecast—very slightly, to be sure—in recognition of that upward movement. However, we now believe that the inflation blip early this year was the result of seasonal

and special factors that are largely past. The behavior of prices since the first quarter has been far better. Competition among U.S. producers is intense, and foreign producers only add to the pressure to hold the line on prices. Labor costs have grown at little more than the rate of growth of productivity. Raw materials prices also have been well behaved.

There is ample evidence elsewhere in the economy that inflationary expectations are very low. As one telling example, those who speculated in gold as a bet that inflation would run out of control probably now wish that they hadn't. The stability of prices is one of the major reasons why the prospects for economic growth in the future are strong.

Interest rates. The major change in the Administration's economic forecast from April to September is in interest rates. We know of no economic model that foretold the magnitude of the reduction of long-term interest rates which has largely resulted from the formulation, announcement, consideration, and adoption of the President's economic plan. The Administration argued from the beginning that adoption of a substantial, credible deficit reduction program would boost economic growth in the long term at minimal near-term cost, because interest rates would fall to help the economy to continue to grow. We maintained that markets would recognize and appreciate that responsible fiscal policy would signal enduring price stability while it reduced Federal demand in the credit markets. Recent history has proven that argument correct.

The financial markets have shown confidence in the prospects for future growth and business profits at the same time that interest rates have declined. The stock market has reached record highs while long-term government bond rates have hit record lows. As further evidence, corporate bond rates have fallen in step with government bond rates, showing again that investors believe that businesses will remain healthy.

The extraordinary magnitude of the drop in interest rates suggests very strongly that the fiscal policy of the 1980s was seriously wrong. The margin of interest rates over the rate of inflation—the so-called "real" interest rate—is a strong indicator of investor expectations. Over the last 10 years, with relatively few and minor episodes, the rate of inflation (excluding the volatile food and energy costs) has remained within a narrow band of from 4 to 5 percent. And yet, for the 7 years from 1986 into 1992, long-term government bond rates remained stuck at much higher levels—for example, the 10-year Treasury Note rate stayed above 7.5 percent. Since mid-1992, inflation has decelerated slightly, perhaps by 1 percentage point; but the drop in bond prices has been far greater, at least 2 percentage points. Investors apparently saw considerable risk that the Nation's economic policy could cause a substantial and sudden increase in government borrowing and inflation, and they demanded a sizable interest rate premium to protect themselves from that risk. Now, that fear has been largely dispelled.

Of course, an even clearer indication of the error of our past fiscal policy was that it was simply unsustainable. Since 1981, the Nation's debt has grown faster than its income. That growing debt begat a debt service cost that has grown faster than the Nation's income. It goes without saying that such a policy had to change. It was running the economy of the United States into the ground.

The remarkable decline in long-term interest rates that has followed from our new economic policy is important for two reasons. First and foremost, as the Administration has maintained, it will provide an important stimulus to investment in productivity-increasing business equipment and consumer durables, and therefore to job creation and economic growth. We always argued that deficit reduction would increase living standards in the long run; the decline in interest rates shows that there is a substantial reward to deficit reduction in the short run as well. Second, it will provide additional deficit reduction in the future. (Note that the current actual 10-year Treasury Note rate is more than $\frac{1}{2}$ percentage point below the Administration's projection.)

Summary. The Administration's economic forecast is little changed from our own projections at the release of the Budget. Our current forecast is somewhat different from the CBO outlook that was used for the budget resolution, however. Our current real growth projections are somewhat less sanguine in the near term, but see a higher long-term sustainable rate of economic growth. We are somewhat less optimistic about inflation, in keeping with the private-sector consensus. Our unemployment projections are slightly lower. Finally, in keeping with recent experience, we see lower interest rates, particularly long-term interest rates, throughout the forecast period. Overall, these changes in economic assumptions reduce the deficit somewhat—but largely on the ground of lower interest rates, which are now established fact.

The Budget and the Economy

On February 17, 1993, President Clinton unveiled a bold plan to revitalize the American economy.

Congress has now acted to put the President's plan in place. On August 10, on the South Lawn of the White House—202 days after taking office and 174 days after his address to the joint session of Congress—the President signed into law the Omnibus Budget Reconciliation Act of 1993.

Enactment of the President's economic plan was a vital first step toward economic renewal, a long-overdue change in the fiscal direction of the nation.

Under the economic plan:

Credible deficit reduction: The deficit will be reduced by \$504.8 billion over 5 years; it is projected to fall below \$200 billion by fiscal year 1996, and to be cut in half as a percentage of GDP by 1998. The rallies in the stock and bond markets confirm the credibility of these projections.

Balanced plan: More than half the deficit reduction (\$254.7 billion) will come from cuts in Federal spending, the rest (\$250.1 billion) from tax increases. All of the tax increases, and two-thirds of the spending cuts, are directed to deficit reduction.

Spending restraints: Spending will be cut for Federal workers' pay and Government administrative expenses, Federal retirement pay, defense, reimbursements of providers under medicare, and other discretionary and entitlement programs.

Tax fairness: Eighty percent of the tax increase will come from households making over \$200,000 of income—the top 1.3 percent of the population. Almost twenty million low-income working families will actually get a tax cut, while only the 1.4 million most well-off American households will pay higher income taxes.

Public investment: Funding will be increased for investment in roads, technology, job training, immunization of young children, early childhood education, crime control and the environment.

The key to better jobs and higher wages is increasing investment. The private sector is the universally accepted leader in achieving prosperity, productivity, and high-wage jobs. But what can the Government do to help?

First, it can stop doing the harm of draining such a large portion of the Nation's saving to finance the Federal deficit; *deficit reduction* will facilitate *private investment*.

Second, and at the same time, it can reorder its spending priorities toward *public investment* that enhances productivity growth and increases long-run economic prosperity.

Third, it must achieve these goals with *tax fairness*—so that middle-class families are protected, and those who have prospered the most carry their fair share.

Deficit Reduction

The benefits of deficit reduction are substantial:

Less Government borrowing: With the Government borrowing less, less of our Nation's savings will be needed to finance the Federal deficit, and more of those savings will be available for private investment that will increase future productivity and wages.

Lower interest rates: Interest rates will be lower—indeed, the Administration's commitment to continuing deficit reduction has already brought interest rates down to historic lows.

Greater private investment: Lower interest rates make it cheaper for business to modernize and for families to buy homes and automobiles, thereby stimulating investment and creating jobs.

Better use of tax dollars: Lower interest costs will also reduce the deficit even further, and enable the Government to devote a higher proportion of its resources to productive investments.

Reducing a large persistent budget deficit is extremely difficult; and for the past 12 years, our fiscal problems have been left to build their own momentum. Only two actions will bring the deficit down directly: spending cuts and tax increases. Both arouse strong political opposition. President Clinton showed leadership and courage in stepping up to the plate with his own specific plan to reorder our priorities, restore tax fairness, and put our budgetary house in order. Further, from the beginning, the President's economic program sought to reduce the deficit by spreading the cuts broadly over regions and programs so that no one is singled out for unfair treatment, as well as helping affected people and communities to adjust.

Public Investment

The private sector needs tools to do its work, and some of those tools can be supplied only by the public sector. President Clinton proposed enough spending cuts not

only to achieve the desired deficit reduction, but also to address neglected productive investments that give our economy the vitality to grow and compete.

Worker skills generated by education and training also increase productivity, wages, and growth.

Basic scientific and technological research underlies much of our private sector activity.

Much of the Nation's infrastructure—roads, bridges, transit, air traffic facilities, water systems—cannot be run at a profit by the private sector.

Tax Fairness

Over the 1980s, the tax burden shifted from upper-income households toward the middle class and the poor. The economic plan reverses those policies. With the pressing need for deficit reduction, tax fairness requires putting the additional burden on those with the greatest ability to bear it.

While typical families struggle in an economy with a shortage of jobs in general, and of high-paying jobs in particular, the Clinton program provides an increased earned-income tax credit to almost twenty million families, and lifts families with two children and a parent working full-time at the minimum wage out of poverty.

The typical middle-class family pays only an additional 4.3 cents per gallon on the gasoline tax, amounting to an average of \$35 per year; because many households contribute a little, the deficit is reduced a lot.

The most well-off Americans should expect to make the greatest contribution to deficit reduction; those with incomes of over \$200,000 per year, about 1.3 percent of all households, will bear about 80 percent of the burden.

Spending cuts

The spending cuts in the President's program include: \$71.3 billion in net savings in *entitlements* and other mandatory spending, including: Cost reductions in Medicare and Medicaid; COLA and other restrictions in Federal retirement programs; reforms in agriculture programs; collecting from private health insurers for non-service-related Veterans medical care; verification of incomes of low-income housing tenants; and auctions to assign the radio spectrum.

A real, enforceable 5-year hard freeze on *discretionary spending* outlays that produces \$107.7 billion in savings. The President has already proposed specific spending cuts in defense and nondefense programs in fiscal years 1994 through 1998, including: Reducing the Federal work force by more than 100,000; eliminating cost-of-living adjustments for Federal employees for 1994; limiting and reducing subsidies; streamlining departments and agencies, and implementing defense savings in keeping with the needs of a post-Cold War world.

Investments and incentives

The reconciliation legislation contains targeted business incentives and investments to expand the job-creating capacity of the private economy and the skills and productivity of American workers, students, and children, including: Tax incentives to promote economic growth and increase the number of jobs, such as: A 75 percent increase in the maximum expensing of investment; a new targeted capital gains cut for long-term investments in small businesses; reforms for treatment of depreciation with regard to the alternative minimum tax; and expansion of the earned income tax credit for working families, especially those with children.

The reconciliation legislation also extends tax incentives which had either expired or were about to expire, including: Employee education assistance; research and experimentation; tax-exempt industrial-development bonds; hiring disadvantaged workers; the exclusion for part of the health-insurance premiums of the self-employed; low-income housing; and mortgage revenue bonds.

Targeted investments proposed by the President in his economic plan for the appropriations process include: One-stop worker training, especially to help those who lose jobs from factory closings or other economic change to upgrade their skills and find new work; National Service program to help students to pay for college; targeted research and dissemination of new technology, through the National Institute of Standards and Technology, the National Science Foundation, the Department of Energy laboratories, and the Advanced Research and Products Administration of the Department of Defense; defense conversion, to ease the transition to the end of the Cold War; research in environmental technologies; a high-speed information highway, to facilitate sharing of information among schools, libraries, businesses, and households; and physical infrastructure, such as highways, mass transit, and other transportation facilities.

The reconciliation bill passed by the Congress provides for investments in mandatory programs, including: Immunizations free to all uninsured children, and to underinsured children at certain Federal facilities, with reduced State expenses for children in the Medicaid program; ten Federal Empowerment Zones and 95 Enterprise Communities; the Mickey Leland Childhood Hunger Relief Act, providing a long-needed increase in food stamp nutrition assistance to those facing high shelter costs, many of whom are families with children; and the Family Support and Preservation Act, keeping families together by teaching parenting and by working with at-risk families to avert the need for foster care.

Revenues for deficit reduction

The reconciliation legislation contains \$250.1 billion in net revenue increases, some 80 percent of which will come from taxpayers with incomes of more than \$200,000—the 1 percent of the population most able to pay. All of these increased revenues are directed to deficit reduction. Revenue-raising provisions include the following: a new 36-percent marginal tax rate on taxable income exceeding \$140,000 for joint returns, \$115,000 for single taxpayers; a new 10-percent surtax on taxable income above \$250,000. Repeal of the \$135,000 limit on income subject to the Health Insurance (Medicare) wage tax; reduction from 80 percent to 50 percent of the deductible amount of business meals and entertainment; elimination of the deduction for club dues; elimination of the deductibility of lobbying expenses; an increase in the top marginal corporate income tax rate, applicable to corporations with taxable income above \$10 million, from 34 percent to 35 percent; a 4.3-cent-a-gallon increase in the tax on transportation fuels; and an increase from 50 percent to 85 percent in the amount of Social Security benefits subject to income tax for the 13 percent of beneficiaries with the highest total incomes.

Budget enforcement

The reconciliation bill contains significant budget enforcement measures to guarantee that deficit reduction is real and that budget discipline is enforced for the next 5 years. These enforcement tools build upon the experience of the last 10 years and strengthen those developed in the 1990 deficit reduction law. The sharp drop in long-term interest rates, along with the rally in the stock market, demonstrate that these spending controls are credible among the most critical observers of Federal government policy.

The budget enforcement tools in the reconciliation bill include: Discretionary spending caps, requiring a 5-year outlay freeze *below* the level of spending of fiscal year 1993—a cut of about 15 percent below the level required to keep up with inflation; “pay-as-you-go” procedures, requiring that entitlement spending and receipts legislation be paid for so as not to increase the deficit, extended on a prospective 5-year basis through fiscal year 1998; sequester mechanisms to enforce both the discretionary caps and the pay-as-you-go requirement.

In addition, the President signed two Executive orders to implement budget controls passed by the House in reconciliation but blocked by a minority in the Senate. They establish: A new separate entitlement budget with numerical targets, which requires explicit action by the President and the Congress if entitlement spending grows beyond the level contemplated in the reconciliation bill; and a deficit reduction trust fund, which prevents the savings of the reconciliation bill from being used for any purpose other than deficit reduction.

Some critics have argued that the current plan cannot succeed because the 1990 budget agreement failed. This criticism is wrong on two counts. First, the 1990 budget agreement did restrain Federal spending. It imposed caps on discretionary spending, which both the Congress and the Executive branch obeyed. (The “emergency” clause in the Budget Act, cited by some as a major loophole, sanctioned a total of \$8 billion in spending over the past three fiscal years—for such obvious disasters as Hurricane Andrew—or only about 1 percent of the deficits over those years.) The agreement also restrained new entitlement spending and tax cuts through a “pay-as-you-go” process, which also has been observed. Thus, the 1990 budget agreement in fact held spending down.

Second, the deficit increased over the projections of the 1990 budget accord for two reasons that do not apply now: because the economy slid into a recession (which began 6 months before the provisions of the budget agreement took effect and was exacerbated by the subsequent Iraqi invasion of Kuwait, which also preceded the budget agreement); and because pre-existing health care programs have grown more rapidly than was anticipated at the time. Today’s situation is different on both of these scores. First, the economic projections underlying the President’s budget program are far more cautious than the rosy assumptions used in 1990; they anticipate

growth very close to the consensus of private forecasters, and they assume interest rates higher than we observe today. And second, we have learned more about entitlement behavior since 1990, and the projections today are more cautious on that front as well. In fact, this Mid-Session Review reestimated entitlement costs downward, because actual data since the beginning of this year show that the budget's projections were too high. Further, the President's program includes substantial cuts in the important medical care entitlements, affecting the very features of the health care system that have added to costs since 1990; and the Administration is preparing a comprehensive health care reform for release later this month.

No one can guarantee the future, and there are contingencies that could push us off of the path that we have drawn in our economic and budget review. However, on the basis of our experience since 1991 and with the budget process improvements enacted in reconciliation—especially those relating to entitlements in general, and medical care costs in particular—there is every reason to believe that the President's plan will bring the deficit down. It is noteworthy that the behavior of the financial markets endorses this view.

The Budget Outlook

Measures of the deficit outlook have changed since the April budget for three reasons: most importantly, policy changes—notably the President's deficit-reduction package; technical reestimates; and the shift from the Congressional Budget Office (CBO) January economic forecast to the new Administration forecast. President Clinton adopted the CBO economic forecast for his Budget to remove differences in economic assumptions from the budget debate. However, the CBO assumptions were based upon the law then in place, not the President's economic program; and the mid-year revision of those assumptions were not yet released when we wrote the *Mid-Session Review*.

The budget deficit outlook is significantly improved.

The 1994 deficit, which was estimated in April at \$305.3 billion, is now estimated to be \$259.4 billion. This is about 4.0 percent of GDP, instead of the 4.7 percent originally forecast. The President's deficit reduction package accounts for the full decline of \$45.9 billion; other influences, including legislation and technical reestimates, cancel each other out.

The 1998 deficit is now estimated to be \$181.0 billion, \$206.7 billion less than the April estimate of \$387.7 billion. Of this change, \$145.8 billion comes from the President's deficit-reduction program, and \$54.4 billion comes from changes in the economic forecast—leaving just \$6.7 billion for all other factors. As a percentage of GDP, the deficit is cut by more than half in 5 years—from 4.6 percent in fiscal year 1993 to 2.2 percent in fiscal year 1998. We estimate that the structural deficit will be cut almost in half—from not quite 4 percent in fiscal year 1993 to about 2 percent in fiscal year 1998.

Under the Administration's projections, by the end of the 5-year budget window, the ratio of the Nation's public debt to its gross domestic product will be stabilized. Since 1981, the debt has grown faster than the economy, with the ratio of the debt held by the public to the GDP increasing from 26.5 percent in 1981 to 51.1 percent in 1992. We estimate that the enactment of the President's economic plan and an improved economic performance will halt the growth of the debt to GDP ratio at 53.2 percent in 1994, and pull it down slightly to 52.9 percent in 1996 through 1998.

I must emphasize, however, that the enactment of the economic program was only the first step in getting the deficit under control. Under the economic plan, most components of the spending side of the budget will merely keep pace with the growth of the economy, and discretionary spending will be frozen in dollar terms over 5 years. However, Federal spending for the health care delivery programs—Medicare and Medicaid—is projected to grow at a rate of more than 10 percent per year. Those programs grow so fast and have already become so large that the deficit cannot be contained without systemic reform of our health care system. The Administration will announce such an initiative later this month.

CONCLUSION

Enactment of the President's economic plan was a long-overdue first step toward economic renewal. Significant deficit reduction will remove the shackles that have constrained the economy for so long—as the significant reduction of long-term interest rates and the rising stock market now demonstrate. America is becoming the Nation in which to invest, innovate, prosper and grow; and the American people will reap the benefits in the form of jobs, income growth, and economic security.

Still, there is more to be done. The Administration will now turn to three critical initiatives to improve the Nation's productivity and reinvent government to do more with less:

Management of the Federal Government, where the National Performance Review, the recently enacted Government Performance and Results Act, mandates of the Chief Financial Officers Act of 1990, reform of the Federal procurement system, and ongoing efforts throughout Government will improve the quality of Government services to the public; reduce the cost of Government operations; and make Government more accountable and accessible to the American people. Further, the Administration is improving the Federal regulatory process, to ensure that regulation protects the health, safety, and well-being of Americans without imposing undue costs, paperwork, uncertainty or delays on businesses or individuals.

Health care, where the Administration will shortly announce major reforms to reduce the rate of growth of costs in both the public and private sectors and ensure that all Americans have secure health insurance coverage.

Trade liberalization, where the Administration is launching a major effort to open foreign markets so that American businesses and workers can compete on a level playing field—including the North American Free Trade Agreement (NAFTA) and the Uruguay Round of negotiations for the General Agreement on Tariffs and Trade (GATT).

This is an ambitious agenda for the President, the Congress, and the Nation. It is my hope that we can work together, on a bipartisan basis, to achieve these goals on the behalf of the American people.

Chairman SABO. Thank you.

I have one brief question before I yield. Maybe you want to answer it for the record.

One of the areas where CBO and OMB estimates vary significantly is the area of projected costs for medicare and medicaid over the next 5 years. Both are showing reductions beyond our policy changes and significant downward estimates of future costs in both medicare and medicaid. But on medicare there is about a \$90 billion difference over 5 years.

If you would, for the record, give us some explanation of why OMB is lower. Just for history's sake we would like some history of CBO and OMB projections compared to what reality was, so we can take a look at that comparison over time.

It is clear that you are right, controlling health care costs is absolutely key if we are going to control long-term deficits. But there is this variation, and we would like to understand why.

Mr. PANETTA. Let me submit that for the record. I can probably comment that the view from OMB's perspective is that if we are going to deal with health care reform, you have got to control both medicaid and medicare costs. And we think that the President's program will do that.

CBO looks at recent history in which medicaid costs have literally zoomed up, more so than what anybody anticipated over the last few years. They have leveled off somewhat as a result of the recovery, but I think that is CBO's concern, and Dr. Reischauer will speak to that.

I think the question in their minds is how successful we can be in truly controlling the costs in medicaid. OMB feels, and the administration feels we absolutely have to control those costs in medicaid expansion and medicare if we are going to get some control over the health care system. That may be the fundamental difference. But I will submit that.

Chairman SABO. If you would, I would appreciate it.

[The information referred to appears at the end of the hearing.]

Chairman SABO. In both projections it is good news that the projections are below what we assumed in earlier estimates, and lower than what we thought they were after our policy changes, but there still is a significant difference.

Let me indicate to the committee before I yield that we intend to have hearings in early October on reinventing government, so members, if they have specific questions on that, will have a chance to ask those questions at a later date.

Mr. Kasich?

Mr. KASICH. Thank you, Mr. Chairman.

Let me first of all say, Mr. Panetta, we tend to see the world in startlingly different ways in terms of these projections. I mean, these projections are based on the fact that all these revenues are going to come in. And we had a long, drawn-out debate in this committee about the boat tax, which we ended up having to repeal because it didn't produce the revenues.

But interestingly enough, Mr. Magaziner was in to see us yesterday and we were asking him about how he was going to pay for this program. He said what he didn't understand about Washington is how is it that whenever businesses trim back expenses and save money, the government doesn't give them any credit, but if we raise taxes, that is a given? We all looked at Magaziner and said, What party are you in? Because his frustration is the same frustration we have.

The only real projections that we have so far that show the success or failure of this problem are the economic growth projections. And you have to bring them down. But we are beyond that—we are going to have that fight again. Maybe we won't. Maybe we will reach some agreement during the next budget.

But, we don't see how you are going to be able to produce these low deficits. We think that this continued slow economy is going to prevent you from being able to do it.

We are going to be with you on reinventing government. I imagine we will be with you on this rescission list. We would like to know how big it is going to be. We would like to know whether we are going to be included in these discussions that come up in September.

But what I would like to know is, if the economy continues to remain flat, what measures will the administration take to get the economy moving again so that people can get jobs?

Mr. PANETTA. I think the important thing right now is to be cautious about how we approach the economy, having put the economic plan in place. The economic plan not only tries to target for these lower deficits. I think the interest rate reaction is an indication of the credibility of the package in trying to achieve those lower deficits.

But there are also some incentives that have been built into the economic package with regards to small businesses, the various depreciation allowances that were provided, the targeted capital gains provision that was part of it, the other small business provisions as well as the real estate provisions. And we really want to give that a chance to take hold.

I think we ought to be watching that economic plan carefully. We should be dealing with health care reform, to try to deal with that problem as well.

We know that we have got to establish a dislocated worker program to deal with the trade impact as well as defense conversion impacts in our economy.

That really is the focal point of our effort right now, to look at those issues. And we are confident that based on what we have put in place. Yes, it is a slow recovery; but on the other hand, it is a recovery that has some very good elements that are supporting it.

We are not looking at a situation where interest rates are going out of hand. We are not looking at a situation where inflation is back as a problem. Those two fundamental principles give us a lot of confidence that the economy is going to grow.

Mr. KASICH. I think it is fair to say this has been your philosophy, and we have got to see whether it works. This is why I say we see things differently. You think low interest rates are the result of confidence in your economic plan. I see them as an indicator that people have a lack of confidence in the economy. Nobody is trying to borrow money because they are apprehensive about the future. We are going to find out who is right.

But the question is, if come next year you are not realizing a growth rate that is going to employ people, are you willing to come up with private sector incentives that are designed to get the economy moving again? Are you then willing to admit that this philosophy of more spending and more government—I don't want to say that, Leon, because that will work you up—if we don't see economic growth or people going back to work, and we ended up being right, that the tax increases dampened the economy, that interest rates reflect a lack of consumer confidence and business confidence in the economy, are you willing to then come back and change your game plan to look at other incentive programs using the private sector to get the economy moving again? Because I think you deserve a trial period.

What would you do if things don't start picking up for you?

Mr. PANETTA. Obviously we are starting on different premises. You view a situation in which people are concerned about the future. We think that people are more hopeful about the future. And if you are right, then the stock market would be down.

Yes, interest rates might be down, but on the other hand, the stock market would be down as well. I think both the stock market as well as the interest rate situation are positive indications about where people think the economy is going. And we need to give this a chance.

But, John, look, in the end both Republicans and Democrats have to continue to monitor the situation. And we will continue to monitor it, and review it to determine whether additional action may be necessary.

At this point we don't think that is the case. But obviously we have to continue to have some monitoring. Because as I said, there are other factors that are affecting our economy. It isn't just the question of an economic plan. It isn't just a question of health care reform or what we do on trade. It is also the issue of what happens in other economies.

We have got to continue to monitor that situation. And we will.

Mr. KASICH. Just a final comment, Mr. Panetta. We can talk about what the stock market means and we can talk about what low interest rates mean, but there is only one bottom line on Main Street, and that is the employment numbers. For today and the foreseeable future, according to both your projections and CBO, you have lowered the economic growth projections, which on Main Street means, I ain't getting a job. And that is the concern that we have.

Maybe you are right. Maybe if we put this plan in, people will have more confidence, they will be buying homes and businesses will be expanding, you will be proven right. I guess we have to wait and see. But we will be back again to visit these numbers, and then if it is not going, we have got to look at some other options.

Mr. PANETTA. As I said, I don't disagree that we have got to continue to look at the situation. The one thing I have tried to do as Director of OMB, and I think what the President has tried to do is try to present credible projections and numbers to the Congress.

We had a debate over the economic plan, but nobody really questioned the numbers that we presented. And CBO and OMB have now gotten much closer together in our projections. At least we are looking at the world in the same way without kidding ourselves as to where we are going.

I have tried not to be overly optimistic. The administration has tried not to present any rosy scenarios here. We tried to be realistic. Hopefully, if we can continue to do that, we will see an improvement in the economy. But it is going to be based only on actions that the Congress and the President are willing to take. If we fail to take those actions, obviously you can see this scenario turn in a different direction.

Chairman SABO. Mr. Kildee?

Mr. KILDEE. Thank you, Mr. Chairman.

Good to have you here, Leon. Just a follow-up on Mr. Kasich's question. In my lifetime the lowest interest rates were under Herbert Hoover. I was born in 1929 and I recall my dad opened a bank account for me for \$5. By 1940 I think I had \$5.85 in that bank account.

Mr. PANETTA. That was a lot of money, Dale.

Mr. KILDEE. Yes, it was. The two times that a consumer goes into the money market generally in my district—probably around the country—is to buy a car and to buy a home. That is usually the two times they feel compelled to go into the money market. The lower interest rate has had, I think, a good effect upon the purchase of cars made in my district, the sale of cars, production of cars. The other time is, of course, to buy a home. Also, of course, government borrows a great deal and that has an effect upon the cost of our debt.

Could you just expand a little more on what you think the effect of the lower interest rates are on the budget in general, and how long do you think they will last, and what effect do you think they will have on the cost of servicing our debt?

Mr. PANETTA. Let me give you the best example, which is something I read in the L.A. Times, in the business section, where they were quoting one individual who as a result of low interest rates

had refinanced the mortgage on their home twice, and as a consequence of that had \$600 more in their pocket. We can talk about all the ways to put money back in people's pockets, but that is real. And that is happening.

We estimate that close to \$100 billion has been pumped back into our economy, largely through refinancing of mortgages, both at the governmental level as well as the individual level. And that is an important step in the right direction.

You can't begin to estimate what the impact of that is overall except to say that the healthiest thing right now is that people do have the opportunity to be able to do that. And it is creating more money out there. And that money, that extra \$600 that that individual gets per month is going to go back into the economy in other ways. That is happening across this country. And I think that is the healthiest thing we can see right now.

I had a discussion with a group of economists the other day who said if there is any consensus right now in Wall Street as well as the financial markets, it is that we are looking at low interest rates in the long term. We are looking at low interest rates in the long term.

Whether you look at Blue Chip or whether you look at CBO or whether you look at OMB when you look at the interest rate projection, everybody has interest rates at a low level into the future. And there is nothing that changes that scenario, that they foresee. If we stick to the economic plan, and do additional deficit reduction, they feel confident that that is a legitimate projection.

So right now there is a consensus that we are looking at low interest rates into the future, and that gives people more dollars to spend each month.

Mr. KILDEE. What effect will that have on our own debt, our own borrowing? How do you project that in the next 5 years, the cost of borrowing money and servicing our debt?

Mr. PANETTA. Obviously that is going to help our numbers as well, in terms of the interest we then have to pay with regards to our own debt. And we project some savings as well on that front. I don't know if we have any numbers.

Joe Minarik, the economist at OMB, tells me that both CBO and OMB look at interest costs as not rising as a percentage of GDP largely as a result of these low interest rate projections.

Mr. KILDEE. Has that changed our ratio between our short-term borrowing and our long-term borrowing, the decision on how to borrow and how the Federal Government borrows?

Mr. PANETTA. There is no question it has some impact with regards to that policy, and that has already been taken into consideration by Treasury Department.

Mr. KILDEE. Thank you very much.

Chairman SABO. We have time for a couple of more people. Mr. Shays and then we will go to Ms. Woolsey.

Mr. SHAYS. Mr. Chairman, I just want to register, Leon, our strong protest that you would come for such a short meeting, have all the members here, make a presentation, and really not allow us in a public forum to examine this. I think if Mr. Darman were here, we wouldn't allow it. And I really make a strong protest to you, Mr. Chairman, that Mr. Panetta should be here longer, he

should be willing to answer the questions of the members of this committee. And I would hope that he would be required and would be willing to come back to allow other members to do their job.

Mr. PANETTA. I have no problem doing that. I have no problem responding to your questions, whether it is in private or public session. I have never had a problem before. It is just that I have a schedule, too, in which—

Mr. SHAYS. I don't want to use more time.

Mr. PANETTA. I have to respond to the President's schedule as well.

Chairman SABO. Don't blame the Director. Blame me.

Mr. SHAYS. I will blame you, because it is wrong to have him come and not be able to have all the members of this committee ask the questions that need to be asked.

Now, I would like to say to you, Leon, that I have tremendous respect for you, and you know that, and I have respect even for the administration, notwithstanding criticism. I am going to be working with them on National Service, on NAFTA, and so are other members. Health care, we want to see a common ground, and we do agree these are common challenges. Reinventing government, I believe we are going to see most of the members here, if we are included in the process, be very willing participants.

But when it comes to the so-called 5-year plan that we are talking about just for this hour, I really think it is pathetic. I don't think it does the job. I would like to briefly tell you why. And your numbers, these are your numbers. The only difference that we would have is I don't call your tax on social security a spending cut. I call it a tax. That is the only difference. But most of the spending cuts—

Mr. PANETTA. So do we, for this purpose.

Mr. SHAYS. Most of the spending cuts are going to take place in the fourth and fifth year. And it is really cutting the growth in spending. If we took no action, spending will go up 27 percent, taxes will grow new revenue about 29 percent. The national debt, if we took no action, would go up 48 percent. That is from \$4 trillion to \$6 trillion.

Now, with the President's plan that we are talking about here, we are seeing spending go up 21.6 percent. We are seeing taxes in a static model go up 34 percent, but they probably won't because people are going to change their behavior with these newer taxes. We are seeing the national debt go up about 41 percent.

Now, what I am going to ask you is this. We know it just barely passed, and no Republican didn't vote for it because we thought it was a good plan but our leaders said don't vote for it. None of us believe this plan does the job.

How are we going to change this 5-year plan so it does the job? Is the reinventing government going to make more cuts than were in the 5-year plan?

Mr. PANETTA. Well, Chris, I have been here for a long time, and every time somebody talks about deficit reduction and they look at a deficit reduction proposal, a lot of people say, that doesn't do the job, for whatever reason, and then they vote against it.

Mr. SHAYS. I voted yes for the 1990 agreement and people said that and they were right and I was wrong.

Mr. PANETTA. I respect people on both sides of this issue as to how they voted. And it doesn't do a hell of a lot of good to rehash it. We went through that debate.

But the fact is that when you are doing deficit reduction, you have got to confront the tough choices, on taxes as well as spending. Putting this first \$500 billion in place is a major step in the right direction, however you feel.

You can argue we should have done a different kind of package, it should have been made up differently, but the fact is we did \$500 billion in deficit reduction, and everybody looks at those numbers and says, that is right, we are doing \$500 billion in deficit reduction. We have got to build on that, and the way to build on that is with reinventing government. We can get additional deficit reduction as a result of reinventing government.

I have to tell you in the 1995 budget process, adhering to those targets, perhaps getting some additional savings in that process is also going to be important. This is a never-ending process.

Nobody is here declaring victory and saying that all of our problems have gone away. We are going to have to continue to work together to control this issue. But nobody, I think, can question the fact that we have taken a major step in the right direction by putting \$500 billion in deficit reduction in place.

Mr. SHAYS. Well, no. I do question it. What I wanted to see was gridlock. I wanted to see what Governor Weicker did in Connecticut. He shut down government. Governor Weld shut down government. His route was cutting spending. They shut down government and got us to do our job.

My question to you, Leon, is this. We have this plan which you call \$500 billion, but \$76 billion is just the change in interest rates, it is not a government action.

Mr. PANETTA. It is a result of government action, though. You don't get \$76 billion in interest savings without doing deficit reduction.

Mr. SHAYS. My point is simply that it is going to go up \$1.6 trillion, notwithstanding the \$500 billion that we can agree on.

My question to you is, how are we going to change the plan so it does more? Is reinventing government going to just incorporate the cuts that are envisioned in this plan, or is it going to go beyond that? Are we going to do more?

Mr. PANETTA. Clearly the point I have made is that this is the beginning of the process and not the end, and that more will have to be done. Obviously health care reform is going to have to be done if we are going to deal with entitlement savings. More needs to be done in the entitlement area. We have got reinventing government which deals with discretionary savings.

The answer is, yes, there is more to be done.

Mr. SHAYS. This is my question, and I am sorry to get so excited about it, but it is so frustrating to hear people on the Floor of the House say, this is just the beginning. If this is just the beginning, what are the other things we are going to do, and what are those numbers? Is reinventing government going to cut more than the President originally expected, and how much more? What are we going to do to make this 5-year plan actually do something beyond the \$500 billion?

Mr. PANETTA. Again, I don't want to beat around the bush, because this \$500 billion is real and it is going to be done and we are going to do everything possible to get it done. We think that these deficit targets are going to be achieved because of this plan being put into place. That is not just my view. It is also CBO, which comes very close to our own projections.

Having said that, this is a question of continuing to look at our budget situation, to find additional savings, to find additional efforts to control entitlements. We are committed to do that.

Mr. SHAYS. Let me just conclude this way. Is reinventing government going to add more savings than is already envisioned in the President's plan? That is my first question.

And my second question is, with the new health care plan, are we going to be adding more government spending, and if so, are we going to offset it?

Mr. PANETTA. The answer to your first question is, yes, we do have more savings that are built into reinventing government. Some of it acknowledges some of the steps that are in place. For example, the 100,000 employees that we have targeted, we had already put into an Executive Order but we are going to be putting that into effect for 1995. But above and beyond that, we are achieving additional savings over this next 5-year period. We have—

Mr. SHAYS. Do you know the amount that would be? Do you have a number we can associate with that?

Mr. PANETTA. In reinventing government there is a proposed target of \$109 billion, as a result of procurement changes—

Mr. SHAYS. Would that be in addition to the numbers in the President's 5-year plan or will they be part of the 5-year plan?

Mr. PANETTA. There is a portion of those on the 100,000 employees that we have already put in place. But the bulk of those savings are new savings that will go for deficit reduction and maybe some additional investment as well.

Mr. SHAYS. I would just conclude with a statement, that to me is the hope if in fact the President comes back and says my 5-year plan needs to be changed, we need to do more, and we can do that, as you say, meeting this as a common challenge, then I think this can work. But if it is not, then it is really going to fail.

Mr. PANETTA. It is only going to work if people are willing to walk the line on tough votes and not run out the back door. That is the only way this is going to work. I have heard all the speeches and I think the real test of whether or not people are serious about this is whether or not they are willing to cast tough votes on entitlement cuts, on spending cuts, on taxes. All three. You cannot do this job just by wishing the deficit down.

Mr. SHAYS. I am sorry, but are you suggesting we are going to have more taxes as well?

Mr. PANETTA. Oh, come on. You know what I am saying. You know what I am saying. That we can talk about this, but in the end it is the willingness of Members to cast tough votes. That is what makes the difference on deficit reduction.

Mr. SHAYS. Thank you.

Chairman SABO. Mr. Parker?

Mr. PARKER. Thank you, Mr. Chairman.

Leon, on page 3 of the CBO's economic and budget outlook, basically what you have there, except for an unemployment rate which goes down a little bit in the projections after 1992, you basically have flat, flat lines. Now, about the only flat lines I know of historically have been people that are dead. Somewhere along the way these flat lines indicate to me that you are kind of waiting to see what is going to happen. I would like for you to explain it for just a moment.

Mr. PANETTA. You are talking about the flat lines on interest rates and inflation?

Mr. PARKER. Well, more so with inflation, with interest rates primarily, because those are the two things that really affect what we do. Are you saying that everything is just going to basically be static, or is that what your office is hoping?

Mr. PANETTA. I will tell you something. If we can hold inflation at current levels, we are doing pretty good. If we can keep low interest rates at the same or lower levels, we are doing pretty good.

Mr. PARKER. There are really only two things that we, as Members of Congress, can control. One is on the tax and the other is on the spend side. To tax or not to tax, to spend or not to spend. Sometimes we think we have a little more effect on interest rates than we do. But it seems to me that somewhere along the way, that we as a body have got to start putting more emphasis on what we can do.

I think that is what you brought up from the spending standpoint and the very hard votes. Because those are the hard votes that are going to be coming up, especially on the entitlement cuts. And unless we get those under control, we are going to continue to have the problem that we have as far as forcing everything else, all the other factors that are out there.

Just one brief question, because I know you must go. Are you concerned with the latest number—I think it came out yesterday—that inflation seems to be moderate to some degree, the increase in the inflation rate?

Mr. PANETTA. When you look at these numbers, you are going to get variations from month to month. But you have to look at the long trends. And every once in a while there might be a slight increase or decrease. But right now I see nothing to change our projection that inflation is going to remain relatively low into the future.

I don't view the numbers yesterday as an indication one way or the other. As a matter of fact, I think they actually confirm that we are not looking at any kind of inflationary pressures right now in the economy.

Mr. PARKER. Thank you, Leon.

Thank you, Mr. Chairman.

Chairman SABO. A final question, Mr. Herger.

Mr. HERGER. Thank you, Mr. Chairman.

Mr. Panetta, it is always good to have you with us.

In the mid-session review, it states, "The economic effects of tax increases and spending cuts are very much the same," and "there is little reason to expect the tax portion of the President's program will exert an irresistible downward pressure on the economy in the near term."

Just recently The American Banker noted, however, that in their opinion record low borrowing activity reflects general pessimism about the Clinton administration's economic policies.

I guess my question is, if you could maybe tell me, if you could, just what school of economics it is that supports the assertion that there will not be a very negative effect due to the administration's largest tax increase in history.

Mr. PANETTA. The main thrust of our policy was to deal with a very fundamental problem, which is the size of the deficit that confronts this country. We are at a \$4 trillion national debt. We have annual deficits, as I said, of \$300 and \$400 billion.

I just would recommend to you that top line. If we fail to do anything, that top line is where the deficit is headed. And we think that when you run those size deficits on a yearly basis, not only does it create unstable interest rates, but it creates a drag on the economy, it takes away from investment capital, it creates a sense that this country has no idea where it is headed for the future, except into greater debt, and towards the edge of bankruptcy.

And that was the fundamental driving force of this package. And the elements of it were a combination of spending cuts as well as revenue increases.

We tried to do it in a fair and balanced way, including people at the upper-income levels. That is where 80 percent of the revenues come from, people over \$200,000. We think frankly at that level of income, it isn't going to create that much inhibition in their investment. But the fact that interest rates are low and that they continue to expand their businesses is going to create additional incentive within the economy.

That is the fundamental principle. Once this country shows a real effort to get the deficit in control, to move in the right direction, that indeed will send an important signal to our society and to our financial markets that we are serious about dealing with this problem.

Mr. HERGER. I appreciate that and I also share the same concern and have, as I know you have over the years, for our growing deficit. I guess the concern that I have, and I believe the concern that many have, and I would have to guess and presume that The American Banker has, is that a plan that seems so very similar to this plan we had back in 1990, where at the same time a \$500 billion deficit reduction was reported to be the result, I guess there is just a lot of concern in our minds, are there some different school of economists out there that are somehow predicting that it will be different this time than it was in 1990?

Mr. PANETTA. As I mentioned in my testimony, I think there are several important distinctions from the 1990 agreement. One is that we are trying to be much more realistic about the assumptions about where the economy is going.

We think that we have a much more credible plan.

And thirdly, we are not confronting the same situation in the economy. We were already into a recession, and that obviously impacted on the level of revenues that came into the Federal Government, as well as the fact that costs on entitlements were not controlled very well in that proposal.

Our effort here is not only to put this into place but also to take the next step, which is to control the program that is the worst villain in entitlements, which is health care. And the President will present that program next week. We will have a major debate in this country, as we should. But that is the next step.

You have to ask yourself this question: If we did nothing, if we did nothing, what would be the situation with regards to taxing our kids to make the interest payments on this debt? We talk about taxes. We think the most regressive tax is the tax on interest on the national debt that goes to our kids and to our grand-kids. We can't just sit back and let that happen.

Secondly, the attitude that when you cut spending or raise taxes, there is a fundamental difference in terms of its impact on people. When you cut spending, you are impacting on people one way or another. I am not saying that is right or wrong, but when you cut benefits on programs, whether it is medicare or medicaid, as far as the person losing that benefit, that is a tax. That is a tax to them.

This argument that somehow you can make this distinction about taxes are all bad, spending cuts are all good. The fact is, both involve some sacrifice. We can't solve this problem unless everybody shares in that responsibility. Everybody. And you can't ask farmers, you can't ask veterans, you can't ask everybody else to share in that sacrifice and then not ask the wealthiest in this country to also participate. It is that simple.

Mr. HERGER. I appreciate that, and again, I share very much the same concerns that you have on the runaway deficit. I suppose our philosophy on how we get from point A to B varies.

Just one other quick question, if I could. In the administration's assumption of a 2.6—I believe it is 2.6 to 3 percent increase in growth rates from the period of 1994 to 1998, could you tell me, is the administration assuming in those growth rates expansion that NAFTA will be passing?

Mr. PANETTA. I believe that our projections are based on policies like NAFTA being enacted. That is correct.

Mr. HERGER. So the answer is, yes, these projections are presuming NAFTA will pass?

Mr. PANETTA. That is correct.

Mr. HERGER. So in other words, then, would you say in follow-up, if NAFTA does not pass—and it does not look very positive at this time—that this growth rate would be moved down in your projections? Do you have an estimate of how much they would be moved down?

Mr. PANETTA. I don't believe we do. I can submit something for the record as to how that would impact. If for some reason NAFTA does not succeed, then we do think that it will have a negative impact in terms of the economy.

[The information follows.]

The economic assumptions in the *Mid-Session Review* assume enactment of the Administration's program. Thus, passage of NAFTA is assumed in the projections. Passage of the Administration's health-care reform was not assumed, however, because the plan was not yet released as draft legislation at that time.

The Administration believes that NAFTA will have a positive effect on U.S. growth, because it will allow our firms to increase production in high-technology, high-wage goods which Mexico needs. Once these opportunities have had their full effects, U.S. GDP will be higher.

However, because the Mexican economy is significantly smaller than ours, and because these effects will be realized only over time, the measured effect of NAFTA within our five-year budget window will be small. The *rate of change* of the GDP in any one year may not be large enough to show up in the economic projections. However, over time, the *level* of GDP will reach a significantly higher level if NAFTA is enacted.

The reason we are supporting NAFTA, the reason we think it is important is because we think it is right for the economy, and our future.

Again, I look at what happened yesterday on the White House lawn, the leadership this country exerts on the world. If we fail to support a proposal like NAFTA, it will be a reflection on this country and our leadership in the world, and also on our word in a treaty.

But the answer to your question is, yes, if it fails to pass, I think it will have some impact in terms of our economy. We will have to roll up our sleeves and go back to work to try to correct that situation.

If health care, for some reason, doesn't pass, if we don't pass health care reform, make no mistake about it, it will have some impact in terms of our projections, because these costs will continue to increase.

So obviously we try to base our assumptions on the policies that we are presenting, and the success of those policies. But if for some reason they don't work, then obviously it is going to have some negative impact, in our view.

Mr. HERGER. Thank you very much.

Chairman SABO. Thank you.

We appreciate your being here again. We look forward to continued contact with you and your office, particularly as we move into hearings on reinventing government.

Mr. PANETTA. Again, I apologize. As I said, I would be more than willing to meet with the members to talk, either in public or private sessions, about these questions.

Chairman SABO. Thank you very much.

We will move very quickly, Dr. Reischauer.

Dr. Reischauer, welcome. As we noted earlier, while you and OMB have some varying estimates, they are remarkable in their similarity. The floor is yours.

STATEMENT OF HON. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. REISCHAUER. Chairman Sabo, members of the committee, I appreciate the opportunity to be here this morning to review with you our latest economic forecast and budget projections, which we released last Wednesday in our update report.

With your permission, I am going to submit my prepared statement for the record.

Chairman SABO. Your entire statement will be in the record.

Dr. REISCHAUER. I will organize my remarks this morning around the questions the Chairman asked in his letter of invitation to me.

The first of those questions asked me to compare our current economic forecast with our winter forecast. Our winter forecast was the one that was used as the basis for the budget deliberations.

The bottom line here is that in most respects the economic outlook has changed little since last winter. That can be seen easily from the second table in the back of my prepared statement.

We still expect the economy to expand at a somewhat subdued pace of between 2.5 percent and 3 percent over the next few years. We have shaved our growth rate about two- or three-tenths of a percentage point over the 1993 to 1995 period. We have bumped up our forecast of inflation a few tenths of a percentage point since March. We have lowered our forecast of interest rates, particularly long-term interest rates, to reflect the dramatic drop that has occurred in long-term rates since our winter forecast.

Even though the economy added roughly 170,000 jobs per month in the first 7 months of this year, we still expect the unemployment rate to fall very slowly as improved job prospects lure more discouraged workers back into the labor market.

In short, the changes in our economic forecast are modest. Furthermore, I would like to reiterate something that Director Panetta said, which is that CBO's forecasts for economic growth and unemployment for 1993 and 1994 are very similar to those of the Blue Chip and the administration. However, the Blue Chip consensus forecast and the administration do expect slightly higher inflation, which would mean correspondingly higher long-term interest rates over this period. But here we are talking about a difference that is really quite modest.

The second question asked in the Chairman's letter was how passage of the 1993 reconciliation act affected our economic forecast. CBO has not attempted to disentangle the impact of the reconciliation act from other interrelated economic developments that have taken place over the last few months. There is, however, no denying that the reconciliation act will impose fiscal restraint that will depress growth over the next few years. One cannot have deficit reduction without having such an effect. There is no free lunch here.

The fiscal restraint of OBRA 1993 will amount to half a percentage point of potential GDP in 1994 and an additional three-tenths of a percentage point in each of the next few years.

Assuming as we do that the Federal Reserve will continue to offset some of this restraint through easier monetary policy, we can expect growth to average about a quarter of a percentage point less than otherwise would be the case over the next 3 to 5 years as a result of the reconciliation action.

Of course, this sacrifice has its rewards. In the short run, the rewards take the form of low interest rates and low inflation. But more important is the long-run impact, and that, after all, is why we are engaged in deficit reduction to begin with. Here we, as well as others, believe that the reconciliation act will enhance growth in the long term and raise standards of living.

Partly because of the reconciliation act, we have raised our estimate of the economy's potential rate of growth to 2.1 percent a year. That is a tenth of a point increase from where we were in March.

The Chairman's letter also asked about the impact of the reconciliation act on CBO's deficit and debt projections. We estimate that OBRA 1993 will reduce deficits by some \$433 billion over the 1994 to 1998 period. These savings are measured relative to CBO's

capped baseline, which presumes adherence to the 1994 and 1995 spending caps that were set forth in the 1990 budget agreement.

The deficit should fall gradually to around \$190 billion in 1996, and then begin to creep up again, reaching about \$200 billion by 1998. Large though this figure is, \$200 billion is a marked improvement over the \$360 billion for 1998 that we projected last March.

Of course, the raw deficit numbers exaggerate the improvement in the fiscal policy outlook. Some of that improvement stems from the extension of the cyclical expansion of the economy. Nevertheless, it is true that the standardized-employment deficit, which is a measure that excludes the effects of the business cycle, shows considerable improvement as a result of the reconciliation act. It declines from 3.3 percent of potential GDP in the current fiscal year to about 2.3 percent of potential GDP in 1998.

Lower deficits will mean less debt. In March, CBO expected the debt held by the public to swell from 51 percent of GDP, where it is in the current fiscal year, to 62 percent of GDP in 1998. We now expect that the debt will only reach 55 percent of GDP by 1998.

Still, we are by no means out of the woods. After 1996, the deficit will begin to rise again if further measures are not adopted to curtail spending or to increase revenues. By the year 2003, the deficit could reach \$360 billion, or 3.6 percent of GDP.

The engine driving this projected increase in the deficit is the inexorable growth expected in the two large health programs, medicare and medicaid. We currently project that even after the reconciliation actions, these two programs alone will grow from 3.5 percent of GDP in the current fiscal year to about 6.2 percent of GDP by the year 2003.

This dramatic increase underscores what Director Panetta was saying and what the President has been saying, which is that we do have to face up to health care reform one way or another in this country.

If one thinks that a balanced budget is an appropriate goal—and we could have a whole hearing on whether it is—a third deficit reduction package that is somewhere between 1.25 and 1.5 times the size of the package you just passed would come close to doing the trick, if you adopted such a package sometime in the next 3 to 4 years. Such a package, however, would not be easy to fashion, as you all know.

In both this year's package and in the 1990 effort, we relied very heavily on just a handful of the less politically painful measures that are out there to reduce the deficit. Specifically, we increased taxes on upper-income folks, we curtailed payments to physicians and hospitals, and we effectively reduced discretionary spending for defense.

These measures may have little to give in the future. And just to illustrate that point, let me say to you that our estimates suggest that after OBRA 1993 is fully in place, the effective tax rates on those in the top 1 percent of the income distribution will be at their highest level since 1979.

Let me conclude—

Mr. SMITH OF MICHIGAN. Excuse me, Mr. Chairman. Would you say that again?

Dr. REISCHAUER. After the full effects of OBRA 1993 have been phased in, effective tax rates on those in the top 1 percent of the income distribution will be at their highest levels since 1979.

Let me conclude by saying a few words about the final issue raised in the Chairman's letter, namely how confident we should be about these deficit projections, considering how far awry CBO's and the administration's projections went after the 1990 agreement was put in place.

We have certainly been humbled by that experience and have devoted considerable resources at CBO to trying to improve the accuracy of our projections. Nevertheless, I would be disingenuous if I did not admit that projecting the deficit remains a highly uncertain business. Just as was the case after the 1990 agreement, it is possible that a combination of slower economic growth and unanticipated increases in entitlement spending and other factors could turn out to rob us of the expected reduction in the deficit.

However, let me also point out that economic and technical reestimates of the deficit need not always go in a pessimistic direction. CBO has just updated its budget forecasts, and our technical and economic reestimates have reduced 1993's deficit by some \$39 billion. And if you look over the entire 5-year period coming up, our new technical and economic reestimates have also improved the overall deficit outlook. So it is not inevitable that we or OMB err in an optimistic direction.

With that, let me conclude. I think I have answered all the questions that were put forward in your letter. I will be happy to answer any questions that the members of the committee might have.

[The prepared statement of Hon. Robert D. Reischauer follows:]

PREPARED STATEMENT OF HON. ROBERT D. REISCHAUER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Chairman Sabo, Congressman Kasich, and Members of the Committee, I am pleased to be with you this morning to review the state of the economy and the budget. Last week the Congressional Budget Office (CBO) released a report, *The Economic and Budget Outlook: An Update*, that describes our current views in considerable detail. My testimony summarizes that report.

Enactment of the Omnibus Budget Reconciliation Act of 1993 has significantly brightened the budgetary outlook for the next several years. CBO now projects that the federal budget deficit will fall from an estimated \$266 billion in the current fiscal year to an average of \$200 billion in 1995 through 1998. Without reconciliation, the deficit would have swelled to nearly \$350 billion by 1998.

Reducing the deficit increases national saving and spurs economic growth in the long run, but it tends to dampen economic activity at first. The drop in long-term interest rates that has occurred this year, however, will offset some of the fiscal restraint from the reconciliation act. The 10-year Treasury note rate fell by roughly a full percentage point between December and August. To some extent this decline in rates stems from the prospect of lower deficits, but economic weakness abroad has also played a role. Whatever their cause, lower interest rates reduce the cost of borrowing, stimulate consumer spending on durable goods and business investment in plant and equipment, and will allow the economy to maintain its momentum during the remainder of 1993 and in 1994.

THE ECONOMIC OUTLOOK

In most major respects, the economic outlook has changed very little since last winter. The economic expansion has become self-sustaining, although the pace of growth is below average for this stage of the business cycle.

Forecast for 1993 and 1994

CBO forecasts that real gross domestic product (GDP) will grow at a rate of almost 3 percent in the second half of 1993 and in 1994. Although the economy grew at an average annual rate of only 1.2 percent in the first and second quarters of 1993, its growth was depressed by several transitory events, including unseasonable weather, changes in income tax refunds, and erratic defense spending. For 1993 as a whole, we project that GDP will grow by 2.3 percent (see Table 1).

The economy added an average of 170,000 new jobs each month during the first 7 months of the year, and job creation is likely to keep on at a moderate pace. The unemployment rate will fall only slowly, however, as improving job prospects lure discouraged workers back into the labor market. Because the economy will be operating at less than its potential, inflation will remain at a modest annual rate of slightly more than 3 percent. Even though our forecast implies that inflationary pressures are subdued, the Federal Reserve has indicated that it will eventually allow short-term interest rates to rise in order to hold inflation in check. In line with the Federal Reserve's policy, CBO forecasts that the 3-month Treasury bill rate will rise from an average of 3.1 percent in 1993 to 3.6 percent in 1994. Long-term interest rates are expected to change little through 1994, however, and the yield curve—now unusually steep—will flatten somewhat.

CBO's forecasts of economic growth and unemployment for 1993 and 1994 are virtually the same as those of the *Blue Chip* consensus of private forecasters. But the consensus expects slightly higher inflation and correspondingly higher long-term interest rates in 1994.

Projections for 1995 Through 1998

CBO does not attempt to forecast cyclical fluctuations in the economy more than 2 years into the future. Beyond 1994, our projections are based on trends in the fundamental factors that determine the potential growth of the economy, including growth in the labor force, productivity, and national saving.

We have raised our estimate of the economy's potential rate of growth to 2.1 percent a year, in part because of the enactment of the reconciliation bill. Some of the reduction in the deficit (we estimate 30 percent) will be offset by reduced private saving, but the rest will be available to increase domestic investment or reduce borrowing from abroad. In either case, U.S. real incomes and living standards will rise more rapidly.

CBO assumes that between 1995 and 1998 the gap between actual and potential real GDP will gradually shrink to its historical average of 0.6 percent. As a result, real GDP will grow at an average annual rate of 2.6 percent over the 1995-1998 period, and unemployment will fall to 5.7 percent (see Table 2). Because GDP remains below its potential, no increase in inflation is projected.

The projections also assume that the interest rate on 10-year notes will remain steady at 6.1 percent from 1995 through 1998. Adjusted for inflation, this rate is lower than what we projected last winter because deficit reduction is expected to ease pressures on capital markets. The 3-month bill rate is assumed to rise gradually to 4.6 percent, bringing the spread between long-term and short-term rates into line with its historical average.

THE BUDGET OUTLOOK

The Omnibus Budget Reconciliation Act of 1993 has made a substantial dent in the annual budget deficits and in the accumulation of federal debt. Last winter, CBO projected that the deficit would grow from \$290 billion to \$360 billion over the 1992-1998 period, and that debt held by the public would swell from 51 percent to 62 percent of GDP. Now, the deficit is projected to fall to \$200 billion over those years, and the debt is expected to reach only 55 percent of GDP.

But two threats cloud the budget outlook. First, experience teaches that budget projections can quickly go awry. Shortly after the 1990 budget agreement was enacted into law, we projected that the deficit would virtually disappear by 1995. But in actuality, slower-than-expected economic growth, unanticipated increases in Medicare and Medicaid spending, and other factors beyond the direct control of the President and the Congress swelled the deficit and necessitated another round of deficit reduction. Second, even if they hold up, the new projections suggest that rising health care costs will cause the deficit to grow again after 1998. By 2003, if current policies are maintained, the deficit would reach \$359 billion.

The Outlook for the Deficit

The deficit record of \$290 billion, set in 1992, is not likely to be broken soon. CBO estimates that the deficit will fall to \$266 billion in the current fiscal year, \$253 billion in 1994, and about \$200 billion a year in the 1995-1998 period (see Table 3). In relation to the size of the economy, the deficit will shrink from 4.9 percent of GDP in 1992 to 2.5 percent of GDP in 1998.

These baseline budget projections incorporate the provisions of the recent reconciliation legislation but assume no further changes in laws and policies affecting tax revenues and mandatory spending. They assume that discretionary spending (that is, spending controlled by annual appropriations) will be held to the limits set by law. The Budget Enforcement Act of 1990 capped discretionary budget authority and outlays through fiscal year 1995, and the Omnibus Budget Reconciliation Act of 1993 extended the caps through 1998. Under these caps, nominal discretionary outlays in 1998 would be no higher than in 1993; in real terms, discretionary outlays would be cut by 14 percent over this period.

Although the budgetary situation is more favorable than it has been for some time, the raw deficit figures exaggerate the improvement in the stance of fiscal policy, because much of the projected reduction in the deficit comes from the cyclical expansion of the economy. When the economy is operating at less than its potential, tax collections shrink, and outlays for unemployment insurance and other benefits grow. As the economy expands, however, this cyclical component of the deficit contracts.

The standardized-employment deficit removes the cyclical deficit from the budget totals and is the best measure of the budget's effect on the economy. It also excludes net federal outlays for deposit insurance, which are highly volatile and do not affect spending by businesses or consumers. The standardized-employment deficit is expected to fall from \$200 billion (3.2 percent of potential GDP) in 1992 to \$154 billion (2.2 percent of potential GDP) in 1995. From 1995 to 1998, however, the standardized-employment deficit grows at about the same rate as the economy's potential output.

The figures on the federal debt paint a more encouraging picture. Since 1981, debt held by the public has quadrupled in dollar terms and has grown from 26 percent to 52 percent of GDP. In sharp contrast, the debt is now projected to grow only to 54 percent of GDP in 1994, 55 percent in 1998, and 59 percent in 2003. Although the reconciliation act has significantly slowed the accumulation of debt, it has fallen short of stabilizing the debt-to-GDP ratio, which many economists view as a minimal requirement for a sustainable fiscal policy.

Changes in the Projections

For the first time in 2½ years, the deficit projections have taken a decided turn for the better. Last March, in our analysis of the President's budgetary proposals, we estimated that the deficit would total \$302 billion in fiscal year 1993 and would reach \$360 billion by 1998. We now project a deficit of \$266 billion in 1993 and \$200 billion in 1998. The reconciliation act deserves most of the credit for the improvement over the long run, but changes in the economic outlook and in technical estimating assumptions also make a small contribution. The lower deficit for 1993 results primarily from the continued failure to provide additional resources for resolving insolvent savings and loan institutions, a modest slowdown in the growth of spending for Medicare and Medicaid, and unexpected strength in revenues.

Changes in law since March have added \$4 billion to the deficit in 1993 but have reduced it by \$26 billion in 1994 and \$143 billion in 1998 (see Table 4). The reductions stem entirely from the Omnibus Budget Reconciliation Act of 1993, which increased taxes, pared entitlement spending, and extended the limits on discretionary spending through 1998. Two pieces of emergency legislation—the Emergency Unemployment Compensation Amendments of 1993 and the Emergency Supplemental Appropriation for Midwest Flood Relief—add slightly to outlays and the deficit.

The revisions to CBO's economic assumptions, described above, also reduce the projected deficits in most years. By 1998, the reduction reaches \$11 billion, thanks mostly to lower long-term interest rates.

Other changes in estimating assumptions, termed technical reestimates, lower the projected deficits by amounts ranging from \$2 billion in 1994 to \$39 billion in 1993. Revised estimates of deposit insurance spending account for the jagged pattern of these changes. In addition, CBO has slightly increased its estimate of tax revenues in all years and has shaved its projections of spending for Medicare and Medicaid.

CONCLUSION

The 1993 reconciliation act has temporarily subdued the deficit, but the deficit threatens to rise again after 1998 unless further steps are taken. This year's bill, like 1990's effort, relied heavily on increasing taxes on upper-income individuals, curtailing payments to physicians and hospitals, and freezing discretionary spending. Achieving further savings in these areas will be more difficult, however, and the next round of deficit reduction is therefore likely to prove even more painful than the last. The budget dilemma will be made still more acute by the Administration's desire to increase access to health insurance and health care, reform the welfare system, and address such domestic needs as crime control, education, and job training—all without imposing major tax increases.

Table 1.

Short-Term Economic Forecasts for 1993 and 1994

	1992	Forecast	
	1993	1994	
Fourth Quarter to Fourth Quarter (Percentage change)			
Nominal GDP			
CBO summer	5.7	5.2	5.2
Blue Chip	5.7	5.1	5.9
CBO winter	5.1	5.4	5.4
Real GDP			
CBO summer	3.1	2.3	2.7
Blue Chip	3.1	2.2	2.7
CBO winter	2.7	2.8	3.0
Consumer Price Index*			
CBO summer	3.1	3.4	3.1
Blue Chip	3.1	3.3	3.4
CBO winter	3.1	2.8	2.7
Calendar Year Averages (Percent)			
Civilian Unemployment Rate			
CBO summer	7.4	6.9	6.6
Blue Chip	7.4	6.9	6.6
CBO winter	7.4	7.1	6.6
Three-Month Treasury Bill Rate			
CBO summer	3.4	3.1	3.6
Blue Chip	3.4	3.1	3.6
CBO winter	3.5	3.1	3.7
Ten-Year Treasury Note Rate			
CBO summer	7.0	6.0	6.1
Blue Chip ^b	7.0	6.1	6.3
CBO winter	7.0	6.7	6.6

SOURCES: Congressional Budget Office; Eggert Economic Enterprises, Inc., Blue Chip Economic Indicators (August 10, 1993).

NOTE: The CBO summer forecast does not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August. The Blue Chip forecast is an average of about 50 private forecasts.

*The consumer price index for all urban consumers.

^bBlue Chip does not project a 10-year note rate. The values shown here are based on the Blue Chip projection of the Aaa bond rate, adjusted by CBO to reflect the estimated spread between Aaa bonds and 1-year Treasury notes.

Table 2.

CBO's Medium-Term Economic Projections (By calendar year)

	1992	1993	1994	1995	1996	1997	1998
Nominal GDP (Billions of dollars)							
CBO summer	5,951	6,267	6,605	6,951	7,317	7,696	8,078
CBO winter	5,943	6,255	6,594	6,942	7,288	7,627	7,953
Real GDP (Billions of 1987 dollars)							
CBO summer	4,923	5,051	5,190	5,330	5,476	5,620	5,755
CBO winter	4,918	5,054	5,204	5,354	5,497	5,628	5,740
Real GDP (Percentage change)							
CBO summer	2.1	2.6	2.7	2.7	2.7	2.6	2.4

Table 2.—Continued
CBO's Medium-Term Economic Projections (By calendar year)

	1992	1993	1994	1995	1996	1997	1998
CBO winter	2.0	2.8	3.0	2.9	2.7	2.4	2.0
CPI-U (Percentage change)							
CBO summer	3.0	3.3	3.2	3.0	3.0	3.0	3.0
CBO winter	3.1	3.0	2.7	2.7	2.7	2.7	2.7
Unemployment Rate (Percent)							
CBO summer	7.4	6.9	6.6	6.3	6.0	5.8	5.7
CBO winter	7.4	7.1	6.6	6.2	6.0	5.8	5.7
Three-Month Treasury Bill Rate (Percent)							
CBO summer	3.4	3.1	3.6	4.1	4.5	4.6	4.6
CBO winter	3.5	3.1	3.7	4.4	4.7	4.8	4.9
Ten-Year Treasury Note Rate (Percent)							
CBO summer	7.0	6.0	6.1	6.1	6.1	6.1	6.1
CBO winter	7.0	6.7	6.6	6.6	6.5	6.5	6.4

SOURCE: Congressional Budget Office.

NOTE: The CBO summer forecast does not incorporate either the advance estimate of second-quarter GDP released by the Bureau of Economic Analysis in late July or the effects of the regular annual revision to the national income and product accounts released by BEA in late August.

CPI-U is the consumer price index for all urban consumers.

Table 3.
CBO's Projections of the Federal Deficit and Debt (By fiscal year)

	1992	1993	1994	1995	1996	1997	1998
In Billions of Dollars							
Total Deficit	290	266	253	196	190	198	200
Cyclical Deficit	93	81	65	52	40	27	18
Deposit Insurance Spending	3	-26	14	-10	-10	-8	-4
Standardized-Employment Deficit ^a	200	211	175	154	160	180	186
Debt Held by the Public	2,999	3,249	3,507	3,713	3,919	4,137	4,357
As a Percentage of GDP							
Total Deficit	4.9	4.3	3.9	2.9	2.6	2.6	2.5
Standardized-Employment Deficit ^{a,b}	3.2	3.3	2.6	2.2	2.2	2.3	2.3
Debt Held by the Public	51.1	52.5	53.8	54.1	54.3	54.4	54.6
Memorandum: Gross Domestic Product	5,869	6,189	6,522	6,862	7,224	7,601	7,984

SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget.

^aExcludes the cyclical deficit, spending for deposit insurance, and (in 1992) contributions for Operation Desert Storm.

^bShown as a percentage of potential gross domestic product.

Table 4.
Changes in CBO's Deficit Projections (By fiscal year, in billions of dollars)

	1993	1994	1995	1996	1997	1998
Winter Baseline Deficit	302	287	284	290	322	360
Changes						
Legislative changes	4	-26	-54	-82	-117	-143
Economic assumptions	^a	-5	-3	1	-2	-11
Technical reestimates						
Deposit insurance	-18	10	-18	-9	6	6
Other	-21	-13	-14	-10	-11	-12
Subtotal	-39	-2	-31	-19	-5	-6
Total	-36	-33	-88	-100	-124	-160
Summer Baseline Deficit	266	253	196	190	198	200

SOURCE: Congressional Budget Office.

NOTE: The projections include Social Security and the Postal Service, which are off-budget.

^aLess than \$500 million.

Chairman SABO. Thank you, Bob.

Let me ask you to do for the record the same thing I asked of Mr. Panetta, and that is to explain to the committee the variations

of medicare and medicaid estimates for the future, and also some history of CBO and OMB projections, as you have them, compared to what those costs actually were.

My understanding is while both of you are projecting lower costs in the future than were projected in March, there is still a large difference between you with CBO projecting higher expenditures than OMB.

Dr. REISCHAUER. That is true. Let me start with the third part of your question, which is what have our track records been in the past.

Chairman SABO. Let's do that for the record. I have some other members here anxious to answer questions.

Dr. REISCHAUER. I was just going to say, the answer is that sometimes we are better, sometimes they are better. That is an easy one.

With respect to medicaid, we have lowered our estimate of costs over the next 5 years by about \$22 billion. OMB has reduced its expected cost for medicaid by about \$36 billion.

Our estimates over this period differ very little, less than \$10 billion in the aggregate. We have lowered our costs because spending by the States for medicaid has slowed way down. It probably slowed way down as a reaction to the 1991 legislation that was passed by the Congress to curtail the abuses in provider tax and donation schemes, which basically the States had been using to rip off the Federal Treasury, and the States pulled back as a result.

With respect to medicare, if you include all of the elements of medicare—the entitlement aspect, the receipts that come in as part B premiums, and the discretionary spending for administration—the administration and CBO differ by less than \$10 billion over this 5-year period—\$7.4 billion, to be exact.

Chairman SABO. I thought it was bigger.

Dr. REISCHAUER. No, I think that is because you are comparing slightly different concepts. We could both be wrong, but there isn't a big difference.

[The information follows:]

CBO AND OMB ESTIMATES OF HEALTH SPENDING

The following table compares CBO and OMB estimates for the Medicare and Medicaid programs as of September 1993. Over the 1994-1998 period, the two sets of estimates are not significantly different. OMB's estimate of Medicare spending exceeds CBO's estimate by a total of \$7.4 billion, or an average of \$1.5 billion a year. Over the same period, CBO's estimate of spending for Medicaid is higher by \$2.0 billion, or \$0.4 billion a year.

(By fiscal year, in billions of dollars.)

	1993	1994	1995	1996	1997	1998
Supplementary Medical Insurance						
CBO	53.7	60.7	70.3	79.8	90.6	102.5
OMB	54.9	62.2	71.5	80.0	89.6	100.2
Hospital Insurance						
CBO	92.0	101.9	110.8	119.0	129.0	140.3
OMB	91.4	101.7	111.2	121.3	131.7	142.3
Premiums						
CBO	-15.7	-17.4	-19.9	-21.0	-23.3	-26.2
OMB	-15.1	-17.4	-19.9	-20.4	-23.2	-26.3
Total, Medicare						
CBO	130.0	145.2	161.2	177.8	196.3	216.6

(By fiscal year, in billions of dollars.)

	1993	1994	1995	1996	1997	1998
OMB	131.2	146.5	162.8	180.9	198.1	216.2
Medicaid						
CBO	76.2	88.3	100.0	111.9	124.8	139.3
OMB	75.0	87.4	100.0	111.7	124.6	138.6

The following table compares the accuracy of CBO and OMB estimates for the Medicare and Medicaid programs for the past five years. The budget year estimates were made about 21 months before the end of each fiscal year. The current year estimates were made about 9 months before the end of the fiscal year. Over the 1989-1993 period, neither CBO nor OMB produced consistently better outlay estimates for these two programs.

(In billions of dollars)

	Medicare			Medicaid		
	Budget Year Estimate	Current Year Estimate	Actual Outcome	Budget Year Estimate	Current Year Estimate	Actual Outcome
FY 1989						
CBO	97.4	98.7	96.5	34.2	34.2	34.6
OMB	92.5	98.3	96.5	32.7	34.3	34.6
FY 1990						
CBO	114.5	106.3	109.7	38.2	39.5	41.1
OMB	110.1	108.2	109.7	36.0	40.2	41.1
FY 1991						
CBO	118.7	116.1	117.8	45.1	49.3	52.5
OMB	115.6	116.3	117.8	44.9	51.5	52.5
FY 1992						
CBO	129.3	131.0	132.3	56.7	68.4	67.8
OMB	129.5	131.8	132.3	59.8	72.5	67.8
FY 1993						
CBO	145.0	149.3	145.7 ^a	79.6	80.3	76.2 ^a
OMB	145.7	147.8	146.3 ^b	84.0	80.5	75.0 ^b

^a Current CBO estimate.^b Current OMB estimate.

Chairman SABO. My understanding is there was a new CPI report today. I wonder if you can respond to that, how that relates to the CPI projections for the year and what its impact might be.

Dr. REISCHAUER. The CPI went up three-tenths of a percentage point for the last month. While this might be a disappointment considering the tiny numbers we have been seeing for the last few months, I wouldn't put too much significance in a monthly figure. It is still true that the CPI has risen by only 2.8 percent over the last 12 months, and over the last 3 months it has risen at a 1.4 percentage point rate.

We have inflation pretty much under control in this country. It is going to go up and down month to month. We will get a big bump when the gas tax goes into effect, but that will be followed by months of very low inflation. I think there is not much to worry about on that front.

Chairman SABO. Thank you.

Mr. Smith? Just so members know the order, Mr. Smith, Ms. Woolsey, Mr. Smith again, a different Mr. Smith, Mr. Price, Mr. Allard, Mr. Stenholm.

Mr. SMITH OF TEXAS. Thank you, Mr. Chairman.

Dr. Reischauer, I would like to start off with a couple of questions about the National Performance Review. What are the CBO estimates as to what savings will be generated by that report?

Dr. REISCHAUER. We haven't analyzed that report yet. We have been asked to, and we will be doing so over the next few weeks.

The report was rather general and didn't provide a whole lot of documentation in terms of the specifics. We will have to get that backup material, which isn't available, before we can come up with a review of the numbers.

Mr. SMITH OF TEXAS. When would you expect your review to be completed?

Dr. REISCHAUER. I can't answer that question until we see the nature of the backup information that is provided to us.

I might point out that the National Performance Review has different components to it. Some of those components involve policy changes: what happens when one reduces the number of field stations in the Agriculture Department or consolidates them, or abolishes the wool and mohair program or the subsidies to beekeepers. Those are relatively easy to cost out.

Others, such as the savings from reducing the Federal work force by 12 percent or reforming procurement, really are extremely difficult to get a hard figure for. They depend on how it is done, where it is done, what offsets there might be.

So I don't want to build up your expectations. There are certain areas where we might be able to provide some hard numbers. There are other areas where, quite frankly it is a wing and a prayer.

Mr. SMITH OF TEXAS. Are you saying it is unlikely you would be able to give us a comprehensive figure of the total savings from the NPR? I guess—let me say also I have read various analyses of it, and some of these analyses that have been published in various papers have said the savings are about half of what the Vice President have announced. They are closer to \$60 billion than to over \$100 billion.

Now, you are saying there is no way to find out if there is even going to be \$60 billion in savings, is that right?

Dr. REISCHAUER. I am not sure which \$60 billion you are talking about. The personnel actions and the procurement reform come to \$60 billion. Those will be hard to estimate. Some of the rest, the programmatic changes, will be easier.

Mr. SMITH OF TEXAS. Let me ask you this follow-up question, if I may. You are saying that some of the proposals, recommendations made in the NPR are not going to be quantifiable? You are going to have to do it on a wing and a prayer.

My question is, if you had to do it on a wing and a prayer, how is the Vice President able to come up with these very specific estimates as to the cost savings?

Dr. REISCHAUER. You know, I speak for many people, but not for the Vice President. I don't know.

Mr. SMITH OF TEXAS. With regard to the mohair program, there are at least two of us here who hope that is not zeroed out. It is a minor part of the overall savings and I hope the savings will be found somewhere else.

Dr. REISCHAUER. Every journey consists of many small steps.

Mr. SMITH OF TEXAS. That is one small step we might omit.

With regard to health care, does CBO have any estimates as to the net cost of the Federal Government of the entire health care program for the first 5 years?

The second question would be, is that including or not including the 37 or thereabouts million people who are uninsured?

Dr. REISCHAUER. Are you talking about the President's health care reform that hasn't been released yet?

Mr. SMITH OF TEXAS. It is like the NPR. It has been announced. I am not sure there is a way to determine what it is going to cost.

Dr. REISCHAUER. We will be estimating the impact of that, but not until we get a proposal that is nailed down with some pretty refined detail.

Mr. SMITH OF TEXAS. A lot of details have been announced, at least they have come from this administration, and you have not done any analysis of that?

Dr. REISCHAUER. No, we have not.

Mr. SMITH OF TEXAS. With regard to the spending cuts bill that the administration has promised us, how much more reduction would you like to see in the deficit, how much more spending cuts would you like to see in order to try to restore health to the economy?

Dr. REISCHAUER. I am not really hired to provide you with advice on how much deficit reduction is sufficient. You have already, whether you like the specific measures or not, taken some very significant steps that will provide quite significant fiscal restraint on the economy in the next year to 2 years. That is going to dampen the growth of the economy.

There is a contradiction here in which one-half of you—meaning you collectively—says: "Why don't you do something about the economy, why don't you make it stronger?" And the other half says: "Why don't you cut the deficit, why don't you impose more fiscal restraint on the economy?" Those are contradictory.

Mr. SMITH OF TEXAS. You are right. I won't ask you to go into that debate. I appreciate what you said about that.

In regard to the deficit reduction plan, CBO estimates that we will reduce the deficit \$43 billion, roughly, as opposed to the \$504 billion estimated by the administration. Where were they wrong? Why were they off over \$70 billion?

Dr. REISCHAUER. I wouldn't use a term as strong as "right" or "wrong." People are measuring the savings against different standards. The administration used a different baseline, not the baseline that has guided congressional action in the past, but the same baseline used for the budget resolution this year. That accounts for roughly \$50 billion of the difference between the administration and us.

The administration also included \$16 billion worth of reduced interest outlays associated with its debt management initiative, shortening the maturity of the debt. We didn't give them any credit for that or didn't count that in our totals because what we are assigned to do is estimate the impacts of congressional action, and this was an executive action.

Mr. SMITH OF TEXAS. The President did say he was going to use CBO figures, the \$430 billion that you all came up? He said that

publicly during the State of the Union address earlier this year, did he not?

Dr. REISCHAUER. I think he said that back at the beginning of his administration with respect to the initial formulation of his budgets.

Mr. SMITH OF TEXAS. Do you see any signs he is continuing to meet his promise to use CBO figures? Any explanation for that?

Dr. REISCHAUER. No.

Mr. SMITH OF TEXAS. That is the last question I have, Mr. Chairman.

Chairman SABO. What he said in his budget message was he was using CBO economic assumptions.

Ms. Woolsey?

Ms. WOOLSEY. Thank you, Mr. Chairman.

I, for one, appreciate our witnesses today and the outlook from today's reports, because I think we have to see this very positively. We are beginning to stabilize our—

Chairman SABO. If you would hold just a second, we are going to try and keep going. So, Mr. Smith, maybe you want to run and vote and come back. Nick, if you want to run and vote and come back.

Mr. SMITH OF TEXAS. Can you go on for 6 minutes?

Ms. WOOLSEY. Well, I don't know.

Chairman SABO. Mr. Allard, we will keep going.

Ms. WOOLSEY. As I was saying, I really am optimistic about beginning to stabilize the deficit to the GDP ratio, the deficit being cut, your prediction of continued low interest rates, and a positive stock market. So there are good things happening, and we have to be glad about that. Thank you for coming, and I appreciate that OMB and CBO are reporting fairly similar figures.

I would like to make a comment that doesn't have anything to do with you directly, Doctor, but I didn't get to comment on when Leon was here and we were talking about employment and jobs. Today The New York Times reported that Japan has announced that their government is investing in their infrastructure and in small businesses to get their economy going and to create jobs.

My question is, to those who voted against the President's stimulus package in the fall, is there a lesson to be learned there, that when you have a slow, flat economy, the government should be getting involved and investing in their people?

Now, my questions to you. As a former small business owner, during the budget debate, I heard a lot from small businesses that they were very concerned that our economic plan, if passed, was going to stifle small business and choke the economy. Do you have any evidence that this is happening, or do you have evidence on the other side that small business is being helped?

Dr. REISCHAUER. It is too early to cite any evidence, because the measures that were passed haven't gone into effect yet. I always have been quite skeptical about the assertion that the deficit reduction package was going to have a significant impact on most small businesses. Most small businesses wouldn't be affected by the higher taxes.

On the other hand, most small businesses, would be affected by the stability that the reconciliation bill has given to our economic

future. This stability, to some small or medium-sized degree, has affected interest rates, and small businesses will benefit because they are borrowers.

So I think on the whole, over the long run, this is a plan that will modestly improve the outlook for virtually all business in America, but particularly small business.

Let me answer the question you didn't ask me, but addressed to your colleagues, which dealt with lessons from Japan. I would suggest that there is another lesson here. Japan is able to do what it is doing, stimulate the economy with more government investment, in part because it doesn't have a fiscal problem. It is a country that has been running budget surpluses. It is a country whose government action on balance has restrained its economy, has increased its national savings.

Unfortunately, we aren't in that position. We are in the position of being a Nation that has a tremendous fiscal problem. And we have to make a trade-off between the short run and the long run. There is no way to avoid that trade-off.

You can have more growth now if you want to put the burdens onto future generations, but we as a Nation have been grappling with that, saying maybe that is wrong, maybe we shouldn't do it, and now we are paying the price for the party we enjoyed during the 1980's.

Ms. WOOLSEY. I have another question, and that has to do with the President's agenda for welfare reform. I would like to ask your opinion and your projections on whether or not we can stay within entitlement ceilings, with health care reform and welfare reform. Because it is my opinion that with these reforms indeed will help stabilize entitlement spending. I would like you to tell me how you see that.

Dr. REISCHAUER. I think in the short run it is very difficult to conceive of a welfare reform program or a health care reform program that saves Federal bucks right out of the gate.

Over the long run, this should be one of the goals of health care reform and welfare reform. However, if you look at our current welfare system, we basically do what is the cheapest way of solving our guilt or our obligation. We put a little money out on the stump and don't provide many support services. Any kind of reform, one that involves worker training or time-limited welfare benefits and some kind of job at the end of that for those who fall through the cracks, ends up in the short run costing money.

I haven't, of course, seen what the President is going to come up with, so I am not trying to criticize the President's plan. Maybe he and his policymakers have solved some of the dilemmas that have baffled welfare experts for decades.

Ms. WOOLSEY. I am hearing you say—and this makes sense to me—is that with a larger investment on the front end, we will get people off of welfare sooner, and there would be a positive budgetary result. But it would cost on the front end—

Dr. REISCHAUER. That is the hope. I think that is a reasonable objective.

Ms. WOOLSEY. Well, thank you very much.

Mr. PRICE [presiding]. We will recoup in a minute here and await the return from the vote of our colleagues.

Dr. Reischauer, I do want to ask you some questions about the macroeconomic effects dealt with in your report as a result of the policy changes we have made. I think the contradiction you have cited is very real and very evident here today. We of course all know that we must be about the task of deficit reduction, of cutting spending.

We also know that this economy has gotten hooked on these \$300 billion annual infusions of borrowed money, and that there are some risks in terms of slowing growth to undertaking these measures.

We have heard some of our colleagues this morning complain that \$500 billion isn't enough, even though when the time came for them to make a decision on this, they could barely break \$430 billion in their own deficit reduction plans. Yet the same members are expressing great anxiety about economic growth and economic slowdown.

So I share those concerns and hope you can shed some light on the situation that we confront.

You say in your report that—you give some assurances that deficit reduction in the long run will lead to a higher level of GDP than what otherwise would have occurred. You say smaller deficits will raise the national savings rate, permit more investment in the long run, resulting in a higher level of input.

But, you say, over the next 3 to 5 years, OBRA 1993 may lower the average growth of input by about one-fourth of a percentage point, assuming the Federal Reserve offsets some of the fiscal restraint.

I wonder if you can elaborate on that a bit. What are we looking at here? Are we looking at a net effect in 1994 of a slowing growth rate? Is that a net effect, even offsetting for lower interest rates and favorable policies from the Fed?

Dr. REISCHAUER. That is our judgment. As I said, our forecast would be perhaps a couple of tenths of a percentage point higher in terms of growth without the reconciliation bill.

I don't want to get into the counterfactual here and say that would be the case if the particular piece of legislation you were dealing with was defeated by one vote as opposed to being passed by one vote, because I quite frankly think there would have been considerable uncertainty and chaos both in the political system and in the financial markets of this country if the reconciliation bill had not passed.

Mr. PRICE. It does raise the question of what baseline or benchmark you are measuring this decline in growth from. What are you assuming about what it would have been otherwise?

Dr. REISCHAUER. Well, as I said in my opening remarks, all sorts of things have been going on in the last 6 months, and they are all to a certain extent interrelated.

When we ask ourselves about the net impact of the reconciliation bill on growth, we are in a way comparing it to a world in which, rather than pledging to enter into a large deficit reduction agreement, the new President said, "We have 2 more years left in the existing one. Over the next year I am going to be fashioning a proposal to provide to the Congress in 1994."

Mr. PRICE. When you talk about—from whatever benchmark you are utilizing—when you talk about a fiscal policy that is turning restrictive by some .7 percent of GDP in 1994, you nevertheless are raising a matter of genuine concern.

Dr. REISCHAUER. The 1990 budget agreement would have caused fiscal restraint in 1994, going from 1993 to 1994, because it imposed some severe limitations on discretionary spending. By enacting the reconciliation bill, you increase the amount of fiscal restraint.

Mr. PRICE. And that is the result of spending cuts, tax increases, entitlement restraints.

Dr. REISCHAUER. Right.

Mr. PRICE. Opponents of this plan assume the only restraint on growth comes from tax increases. Of course we know that tax increases do have a restraining effect. But as you stress, so do spending cuts.

Dr. REISCHAUER. In fact, in the short run, spending cuts probably have a larger restraining effect, and to a certain extent one can argue that tax increases disproportionately aimed at upper-income people are likely to have less short-run restraining effect because more of the increased taxes are likely to come out of savings rather than consumption.

But having said that, I should point out the other side of that coin, which is that the benefits of deficit reduction are commensurately less if that is the case.

Mr. PRICE. Well, my time has expired here, but I want to ask you to elaborate on that for 1 more minute. I think Allen Sinai of Salomon Brothers has recently been quoted as saying that spending cuts have a greater contractionary effect than tax increases. I wonder why that is so. Is essentially what you just said the explanation?

Dr. REISCHAUER. Yes, that is the essential explanation, that some of the increased flow into the government from tax increases does not come out of consumption or spending, but out of saving.

Chairman SABO. Where does all this leave you with respect to the prospect for further spending cuts in fiscal 1994?

I think we are committed to a rescission bill and trying to find additional savings, but we do want to be aware of any potential downside. What would you say about that in terms of the macroeconomic effects?

Dr. REISCHAUER. I would say that if the economy behaves as the consensus of private forecasters and the Congressional Budget Office think—in other words, it chugs along at a rate somewhere between 2.5 percent and 3 percent in the second half of the year and maintains that pace into next year—it would not be a dangerous move to have a further reduction in spending.

However, it will slow down the rate of growth. It will add to the dislocation that is occurring in the economy anyway because of the defense downsizing and other changes that are going on.

You might reasonably ask yourselves how much of this disruption and dislocation you want to concentrate in fiscal year 1994 as opposed to parcelling it out over the 1995, 1996, 1997 period, when the economy should be stronger.

Mr. PRICE. Again, the critics of this plan have tended to minimize the early savings, the 1994-1995 savings, and have said that it is all concentrated in the out years, but from a macroeconomic standpoint you would not stress that. In fact, you would point to how much it is concentrated in 1994.

Dr. REISCHAUER. Yes. And I would point out that one not only has to think of the savings that were enacted in this reconciliation bill, but remember that those savings are being added on to the savings that were required by the discretionary spending caps of the 1990 agreement.

Mr. PRICE. Thank you.

Mr. Smith?

Mr. SMITH OF MICHIGAN. Thank you, Mr. Chairman.

Let me follow up on that just for a minute. In "macro" terms, when we tax business, it has an absolute depressing effect on business expansion. We have sort of suggested that taxing the rich, which does not tax consumption dollars but rather taxes savings dollars, in the short run might be less damaging.

So the question is, how far can the United States, having a lower savings rate than any of the other G-7 industrialized countries of the world, go in taxing savings to reduce deficits, before it catches up with us in terms of being shy dollars that are available for whatever, dollars that are available to buy a new home, to get a college education, most importantly, maybe, dollars that are available to business to expand that business so we can expand jobs?

Dr. REISCHAUER. There is no question that it would be penny wise and pound foolish if the increased tax dollars coming into the Federal Government simply represented a dollar's worth of reduction of private saving. This whole exercise is not about reducing the Federal deficit, it is about increasing national saving, which is a combination of government saving, or deficit, and what happens in the private sector.

Mr. SMITH OF MICHIGAN. Let me move onto another subject—what is our current national public debt?

Dr. REISCHAUER. I think the debt held by the public is about \$3.2 trillion or \$3.3 trillion.

Mr. SMITH OF MICHIGAN. I am talking about the public debt, including what we borrow from social security and the other Federal trust funds.

Dr. REISCHAUER. That is, I believe, about a trillion dollars more. I will have the number for you in a second. That is not an economically meaningful concept. But I will give you the number.

Mr. SMITH OF MICHIGAN. Except when people talk about the public—this Nation's debt today, most people say that it is around \$4.2 trillion.

If you consider real dollars—and I am concerned about the illusion that we have cut out more deficit spending than I think we have—do you agree, Dr. Reischauer, that the increase in public debt, that is the debt that we borrow from everybody else plus what we are borrowing from Social Security Trust Funds, et cetera, that our increase in indebtedness goes up faster over the next 5 years of this budget proposal than it has ever gone up in any 5 years in terms of absolute dollars?

Dr. REISCHAUER. I haven't made that calculation myself. I will be glad to provide you—

Mr. SMITH OF MICHIGAN. I can't believe that.

Dr. REISCHAUER. I think the answer is likely to be yes.

Mr. SMITH OF MICHIGAN. Everybody is working out these charts that says we go from 4.2 to 6.2 roughly over the next 5 years under this proposal. That is \$2 trillion, roughly \$1.9 trillion in the next 5 years.

Dr. REISCHAUER. I say that because you are dealing with total debt, which I think is an economically meaningless concept. I deal with the debt held by the public rather than adding to that the debt one part of the government owes to another.

Mr. SMITH OF MICHIGAN. It seems to me your assumption would be correct if you never intend to pay back the Social Security Trust Fund or the veterans pension funds or any of the other trust funds in government that we are borrowing that money from. And simply instead of paying it back, we are writing another IOU.

So it seems to me there is some legitimacy in considering what we are borrowing from the Social Security Trust Fund and those other funds if we have any intention of paying that money back rather than somehow simply saying that we are going to reduce benefits or some other cost saving idea. You would still question that we should consider that?

Dr. REISCHAUER. There are two issues here. One is how we should consider these pots of money politically. And I think your approach is perfectly valid for the political analysis of this problem.

There is a second way of looking at it, which is the tunnel vision, maybe, of the economist, looking at what effect government activity in the aggregate is having on the resources that are available to the private sector for productive investment. In that sense, it doesn't matter whether we overtax our people for social security this year and build up a—

Mr. SMITH OF MICHIGAN. But you have to agree, if we had a balanced budget in this country, if we had a balanced budget, and if that amount of money that we were borrowing from social security and the other trust funds were temporary, that could be paid back to those funds as we run out of money in the Social Security Trust Fund sometime in the year 2020, rather than increasing taxes.

Dr. REISCHAUER. One would have to remember that when we were running those large deficits by running down the Social Security Trust Fund balances, it would have the same effect in terms of stimulating the economy as we would have—

Mr. SMITH OF MICHIGAN. Let me ask you to get back to me in terms of how fast we are going into debt in this country. My calculations are that we increase the public debt of this country an average over the next 5 years, \$365 billion additional in debt.

Dr. REISCHAUER. I have the numbers here for you.

Mr. SMITH OF MICHIGAN. Since my red light is on, a quick finish-up question. In your January estimate, you showed the consequences of a 1 percentage difference in interest rates in the growth of the economy, in unemployment, and the consequences that would have on increasing the deficit. In your mid-session economic review that came out a couple of weeks ago, you didn't update those figures.

It seems to me the dynamic is so dramatic, that potential cost—that that should be included in that update.

Dr. REISCHAUER. We revise those tables once a year, in our January report. The numbers wouldn't change between January and August.

The first question that we were talking about was the size of the debt. As I said, the debt held by the public will be \$3.2 trillion at the end of this fiscal year. The gross debt, which is the concept you were talking about, will be \$4.3 trillion.

The growth in gross debt, the concept you were referring to, between 1988 and 1993 was \$1.7 trillion, and with the reconciliation bill in place and the estimates all updated, the growth between 1993 and 1998 will be \$1.9 trillion, \$200 billion more than in the previous 5 years.

Mr. SMITH OF MICHIGAN. Should it be a goal, should it be a goal to at least—I mean, the interest on that debt is becoming so overwhelming, do you think it should be a congressional goal to sometime, 5 years, 10 years down the road, live within our means in terms of not increasing that debt, either public or gross or net?

Dr. REISCHAUER. Well, I think—

Mr. SMITH OF MICHIGAN. Mr. Chairman, I have run over.

Dr. REISCHAUER. I think it is important that first of all we control our fiscal system so that debt as a percentage of GDP stops increasing.

I talked in my opening statement about how it was still increasing, although not as fast. The debt as a percentage of our income, in a sense our ability to sustain that debt, has risen from about 26 percent of GDP back in the mid-1970's to 53 percent today, and is still growing. What we want to do is have the economy grow faster than the debt; then the numbers will begin to come down, as they did almost steadily from the end of World War II to the middle of the 1970's.

Whether it is bad to accumulate debt is really a question that depends very much on why that debt is being accumulated. If you are running deficits because the economy is weak temporarily, I don't think you want to change a recession into a depression by imposing fiscal restraint on the economy.

If you are running a deficit because the government is investing in activities or physical assets that are going to benefit the future, I think you would look more benignly on that increase in the deficit.

Mr. SMITH OF MICHIGAN. I am curious about such as what, but I don't want an answer to that question if there are other people that have questions.

Chairman SABO. Thank you.

Mr. Stenholm.

Mr. STENHOLM. Dr. Reischauer, I understand your purpose is not to recommend policy to the Congress, but score us on what we do. You made comment on page 6 in your testimony that discretionary spending is frozen for 5 years, which I think is one of the real pluses of this budget agreement that has been grossly overlooked by many of the critics. There is great significance in freezing discretionary spending for 5 years.

I am a little troubled, though, by a fairly significant discrepancy between your estimates of what our actual deficit reduction is going to be in discretionary spending. The OMB estimates are about \$107 billion in deficit reduction. Yours are considerably less.

Would you explain how much yours are and why they are less than OMB projections?

Dr. REISCHAUER. This is primarily a difference in baselines—in other words, the starting point against which we are measuring the savings. CBO has used a capped baseline to calculate its estimates of the savings in discretionary spending. That capped baseline assumes that the Congress and the Nation would have adhered to the 1990 budget agreement's spending limits in 1994 and 1995, and after 1995, discretionary spending would have been allowed to grow at the rate of inflation.

The administration, and the Congress in its budget resolution, used a different baseline concept, which said that discretionary spending for defense will follow the path laid out in the last real Bush administration budget, and discretionary spending for the nondefense programs will be the 1993 appropriation levels inflated. That gives one a higher baseline against which to measure the new set of caps that were put in place in the reconciliation act.

Mr. STENHOLM. Why did you score it as you scored it?

Dr. REISCHAUER. Because the capped baseline is the baseline that we have been using over the last 3 years, since the passage of the 1990 agreement. To do otherwise would assume that the Congress was not going to adhere to the law of the land.

Chairman SABO. Charlie, if I could just interject a question here, it won't come from your time, just so we have comparison. If the 1993 act had been scored using the same type of baselines as the 1990 act, what would have been the comparable figure?

Dr. REISCHAUER. The answer to that, which we have put in our report, is that the reconciliation act would reduce the deficits over this 5-year period by \$564 billion. But in a sense, the answers are to two very different questions. One question is how much more deficit reduction has been promised now that the 1993 reconciliation bill has been passed than was promised before. That is the question CBO answered.

The second question, which gets you a \$564 billion figure, is, by how much will the Congress have to cut spending and raise taxes over the next 5 years relative to the levels that exist now for program spending in real terms?

In other words, the 1990 agreement promised that you would make some tough decisions for 1994 and 1995 but didn't say what those decisions were going to be. This Congress is going to be responsible for making those decisions. This Congress, the next Congress, and the following Congress are going to have to make the decisions necessary to reduce the deficit by \$564 billion, although some of that action was promised in 1990. But it wasn't specified exactly what it would be.

Mr. STENHOLM. So in effect we are double counting those 1994 and 1995 cuts, but we are specifying them now.

Dr. REISCHAUER. Well, you haven't really specified them. Remember, the discretionary spending caps say that total spending

will be no more than this amount, but it doesn't tell you which accounts are going to get hit.

Mr. STENHOLM. Specifically, now, can you identify some of the accounts that are being cut?

Mr. REISCHAUER. There is a simple answer to that question: it is defense.

Mr. STENHOLM. How much are we cutting defense? Using the 5-year projection which is required under the 1990 Budget Act, and given the assumptions that we have used, how much are we cutting defense? And then could you identify other programs that are being cut, if any?

Dr. REISCHAUER. The answer to that question is impossible to give because the cuts, of course, are decided by annual appropriation actions, with the exception of entitlement cuts and tax increases, which are locked in place for the future. The other cuts, the ones in discretionary spending, are made each year as part of the annual appropriation process. We don't know, you don't know, what those will be.

If you stick with the President's proposal for defense, between 1993 and 1998 defense overall will be reduced by roughly 22 percent in real terms. Nondefense programs in the aggregate would have roughly enough money to keep pace with inflation.

In other words, in the aggregate there would not have to be real cuts in those areas, although clearly the priorities of the Congress and of the administration change over time, and you might want to put more money into worker training or whatever. To do that you would then have to make explicit cuts in other discretionary spending to free up the money. That is what Director Panetta was talking about earlier today when he said that to fit the President's investment package into the 1995 budget, he was having to tell the various agencies that they were going to have to cut back 10 percent, on average, in their noninvestment programs.

Mr. STENHOLM. Briefly, is there any other function of the budget other than defense that you can give me a similar type answer for, a cut in real terms? Is defense the only function of the budget that is getting a real cut, or is there any other aspect?

Dr. REISCHAUER. I can't answer that question until you are finished with the appropriation bills for 1994.

Mr. STENHOLM. But you did it for defense.

Dr. REISCHAUER. I said if you stuck with the President's 5-year defense proposal, this would be the answer. We can look, if we have it, at the function breakdown for the President's plan and provide you an answer to that for the record.

Mr. STENHOLM. I would like to have that very much.

[The information follows:]

DISCRETIONARY SPENDING LEVELS

The following tables show, by function, the discretionary budget authority and outlays for fiscal years 1993 through 1998 in CBO's March 1993 unconstrained baseline and CBO's reestimate of the President's April 8 budget request, as well as the differences between that baseline and the request.

CBO's unconstrained baseline represented CBO's estimate of enacted appropriations in 1993 and those levels adjusted for inflation in 1994 through 1998. It did not include the reductions in discretionary spending needed to comply with the discretionary spending limits for 1994 and 1995 then in effect. The President's April

budget also exceeded the caps for 1994 (outlays only) and 1995 and the limits that have subsequently been established for 1996, 1997, and 1998.

DISCRETIONARY SPENDING

(By fiscal year in billions of dollars)

CBO'S MARCH 1993 UNCONSTRAINED BASELINE

		1993	1994	1995	1996	1997	1998
National Defense (050)	BA	274	288	296	305	314	322
	O	294	290	294	301	308	315
International Affairs (150)	BA	33	22	23	23	23	24
	O	21	22	22	22	23	23
General Science, Space, and Technology (250)	BA	17	18	18	19	19	20
	O	17	18	18	18	19	19
Energy (270)	BA	5	6	6	6	7	7
	O	6	6	6	6	6	7
Natural Resources and Environment (300)	BA	22	22	23	24	24	25
	O	21	22	22	23	24	24
Agriculture (350)	BA	4	4	5	5	5	5
	O	4	4	5	5	5	5
Commerce and Housing Credit (370)	BA	3	4	4	4	4	4
	O	3	3	4	4	4	4
Transportation (400)	BA	14	14	15	15	16	16
	O	36	36	37	38	39	40
Community and Regional Development (450)	BA	8	8	8	8	9	9
	O	8	8	8	8	8	9
Education, Training, Employment, and Social Services (500)	BA	37	38	39	40	41	42
	O	37	38	38	39	40	41
Health (550)	BA	21	21	22	22	23	24
	O	20	21	22	22	23	23
Medicare (570)	BA	3	3	3	3	3	4
	O	3	3	3	3	3	4
Income Security (600)	BA	32	32	33	41	45	43
	O	31	35	37	38	39	41
Social Security (650)	BA	0	0	0	0	0	0
	O	3	3	3	3	3	3
Veterans Benefits and Services (700)	BA	17	18	18	19	19	20
	O	17	17	18	19	19	20
Administration of Justice (750)	BA	14	15	15	16	17	17
	O	15	15	16	16	16	17
General Government (800)	BA	12	12	13	13	14	14
	O	12	13	14	13	14	14
Allowances (920)	BA	0	0	0	0	0	0
	O	0	0	0	0	0	0
Total	BA	517	526	541	564	583	596
	O	548	553	566	580	594	609

Notes: Numbers may not add to totals due to rounding.

BA=budget authority; O=outlays.

DISCRETIONARY SPENDING

(By fiscal year, in billions of dollars)

CBO'S ESTIMATE OF THE PRESIDENT'S APRIL 8 BUDGET

		1993	1994	1995	1996	1997	1998
National Defense (050)	BA	274	264	263	254	248	254
	O	294	279	273	266	250	253
International Affairs (150)	BA	34	22	22	21	21	21
	O	22	22	22	21	21	21
General Science, Space, and Technology (250)	BA	17	18	19	20	21	21
	O	17	18	19	20	20	21
Energy (270)	BA	6	6	7	7	8	8
	O	6	6	6	7	7	8
Natural Resources and Environment (300)	BA	23	20	22	22	23	23
	O	21	22	22	22	23	23
Agriculture (350)	BA	4	5	5	5	5	5
	O	4	5	5	5	5	5
Commerce and Housing Credit (370)	BA	4	3	4	4	4	5
	O	4	3	4	4	4	4
Transportation (400)	BA	15	15	16	17	16	17
	O	36	39	40	41	42	43
Community and Regional Development (450)	BA	11	8	8	8	9	9
	O	8	9	9	8	8	9
Education, Training, Employment, and Social Services (500)	BA	42	43	47	51	53	56
	O	38	40	44	48	52	54
Health (550)	BA	21	22	24	25	26	28
	O	20	22	23	24	25	27
Medicare (570)	BA	3	3	3	3	3	3
	O	3	3	3	3	3	3
Income Security (600)	BA	32	33	36	45	48	48
	O	31	36	38	41	43	45
Social Security (650)	BA	0	0	0	0	0	0
	O	3	3	3	3	3	3
Veterans Benefits and Services (700)	BA	17	18	17	18	18	19
	O	17	17	18	18	18	19
Administration of Justice (750)	BA	15	16	16	17	18	19
	O	17	16	17	17	18	19
General Government (800)	BA	12	13	13	14	14	14
	O	12	13	14	14	14	14
Allowances (920)	BA	0	-1	-1	-1	-1	-1
	O	0	-1	-1	-1	-1	-1
Total	BA	529	509	522	531	535	548
	O	551	552	558	561	556	569

Notes: Numbers may not add to totals due to rounding.

BA=budget authority; O=outlays.

DISCRETIONARY SPENDING

(By fiscal year, in billions of dollars)

CBO'S ESTIMATE OF THE PRESIDENT'S BUDGET MINUS CBO'S UNCONSTRAINED BASELINE

		1993	1994	1995	1996	1997	1998	
National Defense (050)	BA	*	-24	-34	-51	-65	-68	
	0	*	-10	-21	-35	-58	-62	
International Affairs (150)	BA	*	*	-1	-2	-2	-3	
	0	*	*	*	-1	-2	-2	
General Science, Space, and Technology (250)	BA	*	1	1	1	1	1	
	0	*	*	1	1	1	1	
Energy (270)	BA	*	*	1	1	1	1	
	0	*	*	*	1	1	1	
Natural Resources and Environment (300)	BA	2	-2	-1	-1	-2	-2	
	0	*	*	-1	-1	-1	-1	
Agriculture (350)	BA	*	1	1	1	*	*	
	0	*	1	1	1	*	*	
Commerce and Housing Credit (370)	BA	*	*	*	*	*	*	
	0	*	*	*	*	*	*	
Transportation (400)	BA	1	1	1	2	*	*	
	0	*	3	3	3	3	3	
Community and Regional Development (450)	BA	3	*	*	*	*	*	
	0	*	1	1	*	*	*	
Education, Training, Employment, and Social Services (500)	BA	4	5	8	10	12	13	
	0	1	2	6	9	12	13	
Health (550)	BA	1	1	2	2	3	4	
	0	*	1	1	2	3	3	
Medicare (570)	BA	0	*	*	*	*	*	
	0	0	*	*	*	*	*	
Income Security (600)	BA	0	1	3	4	3	5	
	0	0	1	1	2	4	4	
Social Security (650)	BA	0	0	0	0	0	0	
	0	*	*	*	*	*	*	
Veterans Benefits and Services (700)	BA	*	*	-1	-1	-1	-1	
	0	*	*	*	-1	-1	-1	
Administration of Justice (750)	BA	*	1	1	1	1	2	
	0	2	1	1	1	1	2	
General Government (800)	BA	*	*	*	*	*	*	
	0	*	*	*	*	*	*	
Allowances (920)	BA	0	-1	-1	-1	-1	-1	
	0	0	-1	-1	-1	-1	-1	
	Total	BA	12	-17	-19	-33	-48	-48
		0	3	-2	-8	-19	-38	-40

Notes: Numbers may not add to totals due to rounding.

BA=budget authority; 0=outlays.

*Less than \$500 million.

Chairman SABO. Mr. Shays?

Mr. SHAYS. Thank you, Doctor.

You basically, I understand it, are not the Democrat's economic adviser. You are the adviser to the entire Congress. CBO is non-partisan, bipartisan; is that correct?

Dr. REISCHAUER. Nonpartisan.

Mr. SHAYS. You were willing to make a very strong statement that is really your opinion, and we need to know your opinion, but you are willing to say that gross debt is a meaningless economic figure to you. And that simply is not true. Some economists believe gross debt is a very significant figure.

Why are you willing to make the strong statement that to you it is meaningless and therefore to us it should be meaningless?

Dr. REISCHAUER. I am not aware of any economist—and maybe you can get some economic literature for me and educate me on this—

Mr. SHAYS. You are saying that no economist deals—

Dr. REISCHAUER. Let me finish my sentence. I am not aware of any economist who would say the economy would be different if the gross debt were \$100 billion higher or lower than what it is right now, if debt held by the public were unchanged.

Mr. SHAYS. When we have to pay the funds we borrow from the trust funds, we have to pay the interest on that I think, don't we? We pay it back with interest. They basically buy the Treasury but we pay the interest, correct?

Dr. REISCHAUER. But that is a wash. Think of the government as being a pair of pants, and the money in one pocket is being lent to the pocket on the other side. If it is being lent, you have to pay interest, so you take an interest payment out of one side and put it in the other side. My way of looking at this is to ask how much money is in the pair of pants, not which pocket has what amount of money in it.

Mr. SHAYS. Well, okay, but that is your way of looking at it.

Dr. REISCHAUER. But that is how the government's activity affects the private economy. That is what I am talking about.

Mr. SHAYS. I understand that. So it is only meaningless, it is only meaningless if you want to know its effect on how it affects the private economy. So that is the caveat. That is when it is meaningless. But it is not meaningless to us in a budgetary way in how we decide how to appropriate funds and who should get funds and who shouldn't get funds. Then it is not meaningless.

Dr. REISCHAUER. I said it has a political aspect.

Mr. SHAYS. It would be like your saying if we put it all into one pocket, into nondefense, and we have a lump sum, a certain sum, we put it all into nondefense and very little into defense, you would say from an economist's viewpoint that would be meaningless, but to me that is not meaningless as someone dealing with the budget.

I listened to your answer to Charlie's question. Why is it you are willing to say that you knew the effects of defense spending and you made projections? The answer to his question was very real. The real question is, there is only real cuts in defense basically, and in nondiscretionary funds they go up. Isn't that true?

Dr. REISCHAUER. What I said is, we don't know until each year's appropriations are enacted how discretionary spending will be done.

Mr. SHAYS. How do you know about it in defense?

Dr. REISCHAUER. I said to Mr. Stenholm that if we follow the defense proposals laid out in the President's budget for the next 5 years, this would be the effect.

Mr. SHAYS. And he hasn't laid out his spending on—

Dr. REISCHAUER. The President has laid them out, but I don't know the answer to that question, whether some one of the nondefense budget functions might go down in real terms. We haven't looked at it.

Mr. SHAYS. But collectively, nondefense is taking a real cut, and—collectively defense is taking a real cut and nondefense is not taking a real cut. That is basically pretty basic, I think.

Dr. REISCHAUER. I think what I said was, if we follow the President's defense path, there will be enough money left under the caps so that the aggregate of the nondefense sector can roughly keep pace with inflation, which I think is exactly what you said.

Mr. SHAYS. In other words, I guess my point is, I happen to think we need to cut defense. I think Charlie tends to think we shouldn't cut defense as much as we are. I don't want to make assumptions, but I am making an assumption that you have a concern. And it would be helpful just to say yes, if you take all of nondefense and they are not real cuts, and that is the answer to the question. Isn't it?

Dr. REISCHAUER. Is that different from what I said?

Mr. SHAYS. You sure took a heck of a long time to get us there.

Let me ask you this. In your package that you have given us, I know you have to be careful because you don't want to offend Republicans and Democrats and it is a difficult job, but it would be nice just to get a straight answer. In your package, in your presentation, I am trying to reconcile how the administration gets to \$504 billion of deficit reduction, and when you say reduction from the CBO estimate of the administration's baseline, we get \$476.9. It may have been asked, I just don't know, what is that basic \$25 billion, where are we losing that deficit reduction?

Dr. REISCHAUER. I will start with the administration's \$505 billion and try to walk you down to the Congressional Budget Office's figure, \$434 billion worth of savings—

Mr. SHAYS. I will take the \$476.

Dr. REISCHAUER. The \$476 billion isn't absolutely comparable to their \$505 billion because they have made some adjustments in the way they have handled—

Mr. SHAYS. Fine.

Dr. REISCHAUER. They start with \$505 billion. We would subtract \$48 billion of that for baseline differences, which is what you and I have just been talking about.

Then we would subtract an additional \$5 billion because the administration used a higher estimate for the spectrum auction proceeds than the Congressional Budget Office cost estimate. They said, I believe, it would bring in \$12.6 billion. We said it would bring in \$7.2 billion. The congressional accounting I believe was \$10.2 billion. So there is a \$5 billion difference there.

Then there is a \$1 billion difference associated with Nuclear Regulatory Commission fees, the extension of them and how they are accounted for in the baseline.

Then there is a subtraction of \$16 billion that is associated with the debt management savings. As I explained earlier, we don't count those because they are the results of an administrative action. We also don't believe that they are \$16.4 billion. We believe they are \$6.4 billion.

Then there are thousands of other differences that have to do with how much revenue will come in from the various taxes and how much savings will result from the various mandatory spending cuts. They net to a \$2 billion difference, a subtraction of \$2 billion. That takes you from the \$505 billion down to CBO's \$433 billion.

Mr. SHAYS. Let me just be clear. On these two charts, when I look at the problem, I am looking at it not in terms of percent of

the deficit to GDP or the percent of the debt to GDP. I look at it and I say, My God, the national debt would go up 48 percent if we didn't take any action. With the action the President is suggesting, it is going to go up 42 percent. But even taking this—in other words, I don't consider these as valid as looking at some absolute numbers, but even if I look at this, am I correct in making the assumption here that Federal budget deficit as a percent of GDP, you see almost a straight line but slightly down, that is where the administration is hanging their hat, they refer to the percent of the deficit to GDP, whereas your concern focuses more on the Federal debt as a percent of GDP, and you still see that going up, not as much as the red line to credit the administration. We don't see that red line increase, but it is still going up. And your point to us is, that percent of GDP has got to at least not go up and hopefully come down. Is that where you are putting your concern?

Dr. REISCHAUER. Those two charts are connected one to the other.

Mr. SHAYS. True.

Dr. REISCHAUER. Because the debt is simply the accumulation of yearly deficits.

Mr. SHAYS. True.

Dr. REISCHAUER. Your eyes are better than mine or you are closer to the charts. I would say if there is a line on that labeled CBO which says that the deficit as a percentage of GDP will continue to decline in the long run, the chart doesn't go out enough years.

We have it beginning to rise after 1998 as a percentage of GDP. As I suggested, while it might bottom out at 2.6 percent of GDP around 1998, if nothing more is done by the year 2003, it will be back up at 3.6 percent.

So I in no way view this as a piece of business that is finished. We are halfway down the path.

Mr. SHAYS. So basically you are disputing the way that chart is right now, slightly? It does show an even and then a slight decline. You are suggesting it goes up again?

Dr. REISCHAUER. It begins edging up very slowly, though not until we get out to the late 1990's.

Mr. SHAYS. But you mentioned in particular what concerns you is that the percent of the Federal debt to GDP is going up, and you are telling all of us that this is something we have got to notice and look at and deal with; correct?

Dr. REISCHAUER. I am saying that, and as I said to Mr. Smith, we had achieved by the mid-1970's a ratio of Federal debt to GDP of around 25 or 26 percent. Since then, we have let our debt, as a result of big deficits, grow much faster than GDP. Had we allowed that to happen because we were solving some major problems facing this country or because we were investing in the future, we might look at it with a certain degree of equanimity. But that wasn't the case. We consumed it.

Mr. SHAYS. Thank you very much.

Chairman SABO. Let me ask a question about, it comes back, I guess to Charlie's question earlier on what is happening in various functions of government. I see those numbers all the time, divided by our functions.

I am curious, do we have a good analysis of the Federal budget that breaks it down in different categories by, say, personnel costs, procurement costs, a variety of functions like that? Is our accounting system good enough so we get those numbers, accurate figures?

Dr. REISCHAUER. I think there isn't really a need for more or different detail with respect to either the functions of government—health, income security, natural resources, whatever—or personnel procurement, that type of distinction.

Of course, what we really should be asking about is the outputs of government versus the inputs, what resources we are putting in versus the results of that. And it is just very, very difficult. That is what business would want to measure, and that is what the educational establishment would want to measure. It is just very hard to devise good measures of the output of government.

Chairman SABO. I guess I am not sure about the answer.

Dr. REISCHAUER. The answer to your question is, I think we have the specific types of information that you asked for.

Chairman SABO. I think that would be very interesting to look at. As I understand it, what reinventing government is about is basically saying we are going to try to produce whatever we do as government with lower personnel cost. I am not sure to what degree we track contracting out. Sometimes that simply is a substitute for personnel, and I am not sure that is always cost-effective.

But I am just curious if we could put the numbers back together in that fashion. Also, I'd like to see data on grants to State and local governments, separating the health care from others, just so we can see that pattern, and separate it from personnel costs.

I think what is happening is that—I am not sure what the variations will be from function to function, but I think some factors like personnel costs should be coming down in relationship to total expenditures. I am not sure what is happening with procurement. Clearly if we can do that more effectively, that should be coming down.

And I think it would be interesting to look at existing trends. People always get involved in travel, but I think that is probably a small amount in the Federal Government. It is essential in some agencies so we need to know what is happening there.

Charlie?

Mr. STENHOLM. Mr. Chairman, I want to return to the same line of thinking where I was going a moment ago. Dr. Reischauer has agreed to provide information which he didn't have available right now, projecting spending for each of the functions. I think it is important for everyone to understand that that 22 percent cut in real terms is fairly significant in the area of defense. I don't know whether that is too much, too little, or just right. That is part of the discussions that are going on right now on the Floor of the House regarding defense authorizations, appropriations, and setting in concrete the long-term plans for the defense of this country.

I understand the point that you make, and I will look forward to seeing that analysis also for my own edification. The important thing for us to realize is we are going to be in for some interesting discussions in this committee in the next few months as we start setting the priorities for the next 5 years or even the next 1 year.

The exercise of living under the freeze is going to be rather interesting because we are going to see some pretty severe competition among functions for less dollars.

It is also important for the general public to understand that we are talking a freeze in discretionary spending, but we are talking about a 45 percent increase in the mandatory and entitlement side of the budget. Increase. We are talking about expenditures going from \$764 billion to \$1.35 trillion. That is an increase of \$271 billion in increased entitlement spending, an area in which we have thus far been rather unsuccessful in reducing the growth rate.

The biggest part of that entitlement spending is in health care, and that is what Mr. Panetta outlined earlier today. Those are some of the policy decisions that have to be made.

I have one other question which again, you may not have the answer to. When you look at the mandatory spending, we see the "Other" category goes from \$182 billion in 1993 to \$191 billion in 1998, a \$9 billion or 5 percent increase in spending. I am referring to the budget outlook, page 26 I guess in your big book, or page 7 in the summary that the committee has given us here today. That is less of an increase than any of the other mandatory programs.

For the record, I would like for you to give some reason or explanation why that portion of mandatory spending goes up only 5 percent over 5 years. Everything else goes up 45 percent. Civil service, military retirement goes up 23 percent. medicare goes up significantly during that period of time. What is it about that "Other" category that is causing it to go up?

Dr. REISCHAUER. The other category consists of unemployment compensation, which goes down over this period because the economy strengthens, and some programs like veterans' benefits, farm price supports, social services, and the credit reform liquidating accounts, which stay pretty much level during the forecast period.

Mr. STENHOLM. In your analysis you deal with the 13 functions based on projections of the administration budget.

Dr. REISCHAUER. Just one footnote to our discussion on that which has some relevance to what is going on here: remember that the President's budget proposals totaled more than the caps that you passed allow. They were over for both 1994 and 1995, and they were certainly over for the period 1996, 1997, and 1998.

So in a way, what we have in the President's budget is not a particularly meaningful test of what the President will have to propose come January 1994, when he has to produce a budget that fits within the constraints that you have just enacted as part of the reconciliation act.

Mr. STENHOLM. But it would be a very helpful tool, as the other question the Chairman just asked would be, for this committee to have those functional projections. Even though it would be an imperfect document, it would be a very helpful tool for this committee as we try to go through the same basic decision-making process preliminaries.

Dr. REISCHAUER. Fine.

[The material referred to begins on pg. 48.]

Mr. STENHOLM. Thank you.

Chairman SABO. I am curious on one other subject, that is, do you have any analysis of, as it relates to both medicaid and medicare, to the degree that costs are growing faster than changes in inflation and demographics. To what degree is it reflected by the change in demographics of an ever increasing population over age 85, which is growing more rapidly than other portions of the older population?

Dr. REISCHAUER. We did a projection of health care expenditures in this country out to the year 2000. I don't have that with me, but it has a breakdown for demographics. And if I am correct in remembering this, I believe that for the entire growth in health care expenditures, demographics explains only 1 percentage point or less.

Now, that figure might be slightly larger if one just considered medicare. I will get some information on that for you for the record. But I think we have to come to grips with the fact that most of the rapid rise in health care spending, after one subtracts economywide inflation and increases in numbers of people, is from what is called growth in intensity. We are getting more services, and the services we get are more complex and more expensive, and this is a benefit to consumers. Some aspect of this is a benefit.

[The information follows.]

DEMOGRAPHIC FACTORS IN THE GROWTH OF HEALTH SPENDING

Since 1990, personal health spending—the amount spent directly for care of patients—has grown by about 10 percent a year. During the same period, the U.S. population has grown by about 1 percent a year. CBO estimates that the changing composition of the population, particularly the growth in the proportion of elderly persons, adds another one-half of one percentage point to the growth of these health expenditures. In total, therefore, demographic factors account for about 15 percent of the growth in personal health spending.

Since 1990, Medicare spending has also grown by about 10 percent a year. The number of Medicare enrollees has grown about 2 percent a year over the same period. In addition, a small portion of the growth in Medicare spending stems from an increase in the average age of Medicare beneficiaries. Thus, demographic changes explain slightly more than 20 percent of the recent growth in Medicare.

Mr. SMITH OF MICHIGAN. Will the Chairman yield for a follow-up question?

Are you saying 1 percent out of the 100 percent?

Dr. REISCHAUER. I am saying that out of the growth of 10 percent or 9 percent, demographics is 1 percentage point.

Chairman SABO. We thank you for your testimony and your patience in responding to all our questions. Thank you.

[Whereupon, at 12:40 p.m., the committee was adjourned.]

[Additional material submitted for the record follows.]



EXECUTIVE OFFICE OF THE PRESIDENT
 OFFICE OF MANAGEMENT AND BUDGET
 WASHINGTON, D.C. 20503

THE DIRECTOR

October 19, 1993

The Honorable Martin Olav Sabo
 Chairman, House Committee on the Budget
 Washington, D.C. 20515

Dear Chairman Sabo:

This is in response to your question regarding OMB and CBO projections of Federal medical care costs during my appearance before the House Budget Committee on September 14, 1993.

Historically, there have been significant differences in OMB and CBO outlay projections; but those differences often were caused more by technical factors than assessments of the underlying programs. Differences in economic assumptions, for example, can have substantial effects; a difference in the assumed inflation rate for the hospital market basket can move the annual estimates markedly. Further, OMB and CBO often completed technical reestimates of the baseline at different times, which meant that one organization might have six months more of program data upon which to base its projections.

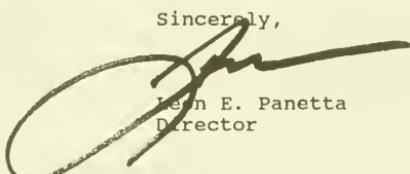
CBO's and OMB's estimates of the effects of recent legislation -- the Omnibus Budget Reconciliation Acts of 1989 and 1990 -- have been quite close. Differences were based on differing economic assumptions (which of course do not imply differing views of the underlying programs); differences in baselines; and differing data bases for analysis. The first problem does not apply to the current reconciliation bill, because CBO and OMB used the same economic assumptions; the second problem also did not apply; and the last problem has been addressed through improved information sharing.

Over the next five years, OMB's projections for Medicare differ from CBO's by only about \$28 billion, which is just 0.3 percent of the total baseline. Almost all of this difference is in Part B outlays. CBO assumes a one to two percentage point higher annual growth rate than the HHS actuaries, due to more pessimistic assumptions about utilization rates and the effect of the new physician payment method (RBRVS). This differential has been acknowledged by CBO, OMB and HHS for several years.

Enclosed you will find brief papers analyzing the differences between CBO and OMB scoring of the 1989, 1990 and 1993 reconciliation bills, along with quantitative tables to document the analyses.

I hope that this information is helpful.

Sincerely,


 Leon E. Panetta
 Director

Enclosures

OMB - CBO Scoring Differences in Medicare and Medicaid in OBRA 93

Most of the dollar differences in savings estimates between OMB and CBO are attributable to similar, not the same, baselines and baseline growth assumptions. The total difference in OBRA 93 scoring estimates for both Medicare and Medicaid was \$7.451 billion, or 0.5% of combined spending of \$1.604 trillion (CBO) during FY 1994- 1998. The year-by year differential quickly narrows, then stays about the same in the later years. The compounding effect of varying baseline assumptions made one, five, or ten years ago can have major affects on future spending estimates and related savings.

Medicare

The total difference in OBRA 93 scoring estimate was \$6.647 billion over five years. Of that difference, \$4.3 billion is attributable to Part B premium collections. CBO and the Administration baselines use different growth rates for Part B utilization projections, leading to this difference. The scoring differential is equal to 0.6% of total Medicare outlays of \$1.04 trillion (CBO) during FY 1994 - 1998. In aggregate the CBO baseline is 2.9% higher than the HHS baseline, with the CBO Part B baseline accounting for virtually all of the differential

Medicaid

The total difference in OBRA 93 scoring estimate was \$804 million over five years, or 0.1% of projected outlays of \$564 billion (CBO) during 1994 - 1998. The differences get smaller in later years. The CBO baseline is 0.4% higher, or \$2 billion more, than the HHS baseline for the period.

HI OMB-CBO Pricing Analysis

OBRA'89

CBO scored \$0.1 billion more in savings than OMB for 1990 (approximately 9% of total Medicare savings for that year) and \$0.7 to \$0.9 billion more in savings in each of the years 1991 to 1994 (85% of total Medicare savings 1990-1994). Most of the difference resulted from varying analytical approaches for a few large provisions.

The largest differential was the expected savings for the Medicare Secondary Payor Information program, which accounted for over half of the differences. OMB scored the proposal assuming a slow start-up period and then a steady savings stream, while CBO assumed quick savings with a gradual phase-down to minor savings due to a behavioral shift by insurance carriers. This modeling difference ties to changes not likely to be repeated. Recent HHS letters indicate OMB scoring reflects actual results.

Three other valuation differences produced almost all of the remaining difference. First, there were seven provisions that CBO counted as savings and OMB scored in the OMB baseline. Under the determinative scoring in the Budget Enforcement Act, this situations should not occur. Second, OMB and CBO score the inpatient hospital capital provision using different hospital market basket assumptions, which resulted in large (\$0.1 billion) first-year differences. Finally, OMB and CBO used different behavioral and eligibility assumptions for the hospital payment update in general and sole community, inner city and disproportionate care hospitals specifically. Better data sharing between CBO, OMB and HCFA and now-consistent definitions of eligibility should remove much of the difference, while a small behavioral gap remains.

OBRA '90

CBO scored \$0.4 billion more in savings in 1991 than OMB (14% of total Medicare savings for that year), and less savings of \$0.1 to \$0.2 billion in each of the years 1992 to 1995 (0.5% of total Medicare savings for 1991-1995).

In comparison to OBRA'89, much more of the HI scoring difference came from different scoring of the hospital payment update because many provisions that CBO scored as savings were already included in OMB's baseline (specifically the hospital urban/rural differential phase-out, the disproportionate share payment increase and the regional floor extension). Differing economic assumptions added to the difference because CBO projections included small savings due to a lower projected tax base. This gap should close under BEA because the economic assumptions used by OMB now support CBO long-term forecasts.

As was the case for OBRA '89, different assumptions on phase-in on the Secondary Payor provision explain a large part of the HI difference. OMB assumed a relatively quick build-up of savings with a steady stream in the out-years, while CBO expected a slower savings build-up.

Scoring differences for inpatient hospital capital payments reflected separate underlying data sets used and varying assumptions on changes in capital expenditure behavior. CBO scores hospital physician education recoupment as savings, while OMB believes such provisions already exist under current law. The difference in the PPS-exempt hospitals comes from different update factors projected from the last year of actual cost data. This gap should close under BEA because the economic assumptions used by OMB now support CBO long-term forecasts.

OMB and CBO Baseline Estimates Pre- and Post OBRA '93							10/15/93 5:01 PM
	1994	1995	1996	1997	1998	5-Yr. Total	Comments
<i>Mid-Session Review September 1993 Baseline - Pre-OBRA '93 savings</i>							
Medicare Part A							
CBO	103,140	114,259	125,592	137,371	149,362	629,724	CBO is 0.8% higher than HHS
HHS	101,451	112,684	125,291	137,085	148,305	624,816	
Medicare Part B (gross outlays)							
CBO	61,385	71,908	83,428	95,968	109,606	422,295	CBO is 2.0% higher than HHS
HHS	61,105	71,431	80,961	93,457	107,230	414,184	
Total Medicare							
CBO	164,675	186,563	210,430	236,006	262,997	1,052,019	CBO is 1.2% higher than HHS
HHS	.	162,556	184,115	206,252	230,542	1,039,000	
<i>Reconciliation Savings</i>							
Medicare Part A							
CBO	(966)	(3,071)	(5,301)	(6,608)	(7,338)	(23,284)	
HHS	(1,365)	(3,918)	(7,102)	(8,502)	(9,302)	(30,189)	
Medicare Part B (includes premium savings)							
CBO	(652)	(1,746)	(4,177)	(6,860)	(9,986)	(23,421)	CBO has a \$8 B higher
HHS	(555)	(1,527)	(2,571)	(5,524)	(8,759)	(18,936)	Part B baseline, resulting
Medicare A/B							
CBO	(457)	(646)	(2,152)	(2,938)	(2,873)	(9,066)	\$4.3 billion more in
HHS							premium savings.
TOTAL							
CBO	(2,075)	(5,463)	(11,630)	(16,406)	(20,197)	(55,771)	
HHS	(1,920)	(5,445)	(9,673)	(14,026)	(18,061)	(49,125)	
<i>Post-Reconciliation Medicare Baseline</i>							
CBO	162,600	181,100	198,800	219,600	242,800	1,004,900	CBO is 1.5% higher than HHS
HHS	160,636	178,670	196,579	216,516	237,474	989,875	
Difference, CBO - HHS	1,964	2,430	2,221	3,084	5,326	15,025	

OBRA 93 Reconciliation Scoring Medicare and Medicaid		(\$ in millions, by FY)					Total
Section #	Section Title	1994	1995	1996	1997	1998	1994 - 1998
MEDICARE							
Part I - Provisions Relating to Part A							
13501	Payments of PPS Hospitals (includes Capital Reduction, Medicare Dependent Small Rural Hospitals, Regional Referral Centers, Wage Index Hold Harmless, and Extension of Regional Payment Floor)	HHS 1,140 810	HHS 3,155 2,758	HHS 5,380 4,825	HHS 6,790 6,125	HHS 7,550 6,868	HHS 24,015 21,386
13502	Reductions in Payments for PPS-Exempt Hospitals	HHS 10 CBO 16	HHS 20 CBO 44	HHS 30 CBO 111	HHS 50 CBO 172	HHS 50 CBO 188	HHS 160 CBO 531
13503	Reductions in Payments for Skilled Nursing Facility Services	HHS 100 CBO 127	HHS 240 CBO 237	HHS 230 CBO 305	HHS 150 CBO 231	HHS 160 CBO 191	HHS 880 CBO 1,091
13504	Reductions in Payments for Hospice Services	HHS 20 CBO 20	HHS 50 CBO 42	HHS 90 CBO 69	HHS 110 CBO 89	HHS 120 CBO 102	HHS 390 CBO 322
13505	Hemophilia Pass-Through Extension	HHS 0 CBO -5	HHS 0 CBO -4	HHS 0 CBO -1	HHS 0 CBO 0	HHS 0 CBO 0	HHS 0 CBO 0
13506	Graduate Medical Education Payments in Hospital-Owned Community Health Centers	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO 0
13507	Extension of Rural Hospital Demonstration	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO *	HHS 0 CBO 1
13508	Reduction in Part A Premium for Certain Individuals with 30 or More Quarters of Social Security Coverage	HHS -5 CBO -2	HHS -5 CBO -6	HHS -5 CBO -8	HHS -10 CBO -9	HHS -15 CBO -11	HHS -40 CBO -36
<i>Subtotal, Part A</i>		HHS 1,265 966	HHS 3,460 3,071	HHS 5,725 5,301	HHS 7,090 6,608	HHS 7,865 7,338	HHS 25,415 23,295

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		OBRA '93 Reconciliation Scoring Medicare and Medicaid (\$ in millions, by FY)								
Section #	Section Title	1994	1995	1996	1997	1998	Total 1994-1998			
Part II - Provisions Relating to Part B										
Subpart A - Physicians' Services										
13511	Reduction in Default Update for Conversion Factor for 1994 and 1995	HHS CBO	240 276	700 765	960 1,020	1,060 1,130	1,170 1,248	4,130 4,439		
13512	Reduction in Performance Standard Rate of Increase and Increase in Maximum Reduction Permitted in Default Update	HHS CBO	0 0	0 0	190 163	630 601	1,200 1,247	2,020 2,011		
13513	Practice Expense Relative Value Units	HHS CBO	90 82	260 237	490 442	630 559	690 617	2,160 1,937		
13514	Separate Payment for Interpretation of Electrocardiograms	HHS CBO	5 6	5 11	5 8	5 5	5 5	25 36		
13515	Payments for New Physicians and Practitioners	HHS CBO	5 0	10 1	10 2	15 3	20 4	60 10		
13516	Payments for Anesthesia	HHS CBO	30 27	60 58	90 85	120 113	150 146	450 429		
13517	Extension of Physician Payment Provisions to Nonparticipating Suppliers and Other Persons	HHS CBO	0 8	0 12	0 11	0 10	0 9	0 50		
13518	Antigens under Physician Fee Schedule	HHS CBO	0 0	0 0	0 *	0 .	0 .	0 .		
Subpart B - Outpatient Department Services										
13521	Extension of 10 Percent Reduction in Payments for Capital-Related Costs of Outpatient Hospital Services	HHS CBO	0 0	0 0	190 128	230 150	260 174	680 452		

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OBRA 93 Reconciliation Scoring Medicare and Medicaid
(\$ in millions, by FY)

Section #	Section Title	1994				1995				1996				1997				1998				Total 1994-1998
		Subpart E - Other Provisions																				
13551	Payments for Clinical Diagnostic Laboratory Tests	HHS	110	280		470		570		650		650									2,080	
		CBO	150	430		720		919		1,084											3,303	
13552	Extension of Alzheimer's Disease Demonstration Projects	HHS	5	0		0		0		0		0		0		0		0		0	5	
		CBO	-12	-2		0		0		0		0		0		0		0		0	-14	
13553	Oral Cancer Drugs	HHS	-50	-90		-95		-100		-110		-110		-110		-110		-110		-110	-445	
		CBO	0	0		0		0		0		0		0		0		0		0	0	
13554	Clarification of Coverage of Certified Nurse-Midwife Services Performed Outside the Maternity Cycle	HHS	0	0		0		0		0		0		0		0		0		0	0	
		CBO	*	*		*		*		*		*		*		*		*		*	2	
13555	Increase in Annual Cap on Amount of Medicare Payment for Outpatient Physical Therapy and Occupational Therapy Services	HHS	0	0		0		0		0		0		0		0		0		0	0	
		CBO	-4	-6		-7		-7		-9		-9		-9		-9		-9		-9	-10	
13556	Rural Health Clinics and Federally Qualified Health Centers	HHS	0	0		0		0		0		0		0		0		0		0	0	
		CBO	-4	-7		-8		-8		-8		-8		-8		-8		-8		-8	-36	
13557	Extension of Municipal Health Service Demonstration Projects	HHS	-20	-25		-30		-35		-40		-40		-40		-40		-40		-40	-120	
		CBO	-12	-19		-20		-22		-22		-22		-22		-22		-22		-22	-81	
<i>Subtotal, Part B</i>																						13,755
13561	Medicare as Secondary Payor	HHS	50	100		810		1,160		1,210		1,210		1,210		1,210		1,210		1,210	3,430	
		CBO	23	36		1,054		1,583		1,811		1,811		1,811		1,811		1,811		1,811	4,507	

Part III - Provisions Relating to Parts A and B

Section #	Section Title	OBRA 93 Reconciliation Scoring Medicare and Medicaid (\$ in millions, by FY)						Total 1994 - 1998
		1994	1995	1996	1997	1998		
13562	Physician Ownership and Referral	HHS CBO	0 0	50 50	100 100	100 100	100 100	350 350
			Note: HHS, not OACT pricing					
13563	Direct Graduate Medical Education	HHS CBO	10 1	50 27	120 66	130 73	140 75	450 242
13564	Reduction in Payments for Home Health Services	HHS CBO	80 201	290 421	590 764	320 901	220 598	1,500 2,885
13565	Immunosuppressive Drug Therapy	HHS CBO	0 0	-20 -7	-60 -23	-95 -46	-115 -77	-290 -154
13566	Reduction in Payments for Erythropoietin	HHS CBO	45 31	65 52	65 56	85 62	90 67	350 267
13567	Extension of Social Health Maintenance Organization Demonstrations	HHS CBO	0 -2	0 -5	0 -7	0 -8	0 -3	0 -25
13568	Timing of Claims Payment	HHS CBO	-20 200	0 24	0 28	0 30	0 33	-20 315
13569	Extension of Waiver of Watts Health Foundation Demonstration	HHS CBO	0 3	5 5	0 5	0 6	0 6	0 25
	Subtotal, Parts A & B	HHS CBO	165 457	535 603	1,625 2,043	1,700 2,701	1,745 2,610	5,770 8,414

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OBRA 93 Reconciliation Scoring Medicare and Medicaid (\$ in millions, by FY)

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OMB-CBO Pricing Comparison - Detail

OBRA 90 Part A Provider Savings

	1991	1992	1993	1994	1995	
Hospital Update						
OMB	590	1860	2910	3220	3340	• Interpretation of
CBO	385	1335	2240	2445	2485	Committee Language
Difference	205	525	670	775	855	• Models use different inputs
Inpatient Hospital Capital						
OMB	960	910	940	1020	1050	• Different economic
CBO	810	720	760	840	920	assumptions create lower
Difference	150	190	180	180	130	CBO update factor
DRG Payment Window of 72 Hours						
OMB	50	80	100	110	120	
CBO	45	110	120	135	145	
Difference	5	-30	-20	-25	-25	
Freeze Part A Payments to 12/31/90						
OMB	530	0	0	0	0	
CBO	495	0	0	0	0	
Difference	35	0	0	0	0	
Secondary Payor Part A Portion (CBO Estimate Split 45% Part A, 55% Part B) • OMB tried to conform to						
OMB	10	560	820	895	860	CBO OBRA 89 method, but
CBO	0	338	581	761	887	CBO changed assumptions.
Difference	10	222	239	134	27	
Hospice Benefit Expansion						
OMB	0	-1	-1	-1	-1	
CBO	0	-1	-1	-1	-1	
Difference	0	0	0	0	0	
PPS_Exempt Hospital Adjustment						
OMB	0	-50	-70	-70	-80	• OMB includes HHAs and
CBO	0	-20	-35	-40	-45	other organizations, while
Difference	0	-30	-35	-30	-35	CBO does not
Miscellaneous and Technical Part A Provisions						
OMB	-40	-50	-50	-70	-70	
CBO	0	0	0	0	0	
Difference	-40	-50	-50	-70	-70	
Payments for medical education costs						
OMB	570	440	290	280	-230	
CBO	205	220	115	-15	-45	
Difference	365	220	175	295	-185	
OMB	2670	3749	4939	5384	4989	21731
CBO	1940	2702	3780	4125	4346	16893
Difference	730	1047	1159	1259	643	4838

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OMB-CBO Pricing Comparison - Detail

OBRA 89 Part A

	1990	1991	1992	1993	1994	
Hospital Update						
OMB	-130	-220	230	-290	-340	+ Considered
CBO	-100	-180	190	-210	-230	given differen
Difference	30	-40	-40	-80	-110	baseline spendi growth.
Inpatient Hospital Capital						
OMB	620	150	0	0	0	+ CBO and OMB use
CBO	480	100	0	0	0	0 different data set
Difference	140	50	0	0	0	Data lags of three years make
Inner City/Rural DSH						projections difficul
OMB	-60	-180	-200	-220	-240	+ Attributes problem
CBO	-95	-285	-315	-345	-375	behavioral
Difference	35	105	115	125	135	assumptions and eligibility criteria viewed differently.
Medicare-Dependant Small Rurals						
OMB	-5	-55	-70	-20	0	
CBO	-5	-45	-65	-20	0	
Difference	0	-10	-5	0	0	
EACH Demo Grants						
OMB	0	0	0	0	0	+ Baseline issue in
CBO	0	-10	-20	-25	-25	-25 scoring. OMB doesn't
Difference	0	10	20	25	25	score on appropriated amounts.
Rural Referral Centers						
OMB	0	0	0	0	0	+ Baseline issue in
CBO	0	-25	-30	-15	-15	0 scoring. OMB doesn't
Difference	0	-25	-30	-15	0	0 score on appropriated amounts.
Sole Community Hospitals						
OMB	-5	-40	-50	-55	-60	+ Attributes problem
CBO	-10	-75	-120	-140	-150	behavioral
Difference	5	35	70	85	90	assumptions and eligibility criteria viewed differently.
Cancer/Long-term hospitals-- Exempt/Rebase						
OMB	-5	-5	-10	-10	-10	
CBO	-16	-13	-14	-15	-16	
Difference	11	8	4	5	6	
Hospice Payment/CPI						
OMB	-20	-30	-40	-50	-60	
CBO	-15	-25	-30	-35	-40	
Difference	-5	-5	-10	-15	-20	
Hemophilia Clotting Factor						
OMB	1	0	0	0	0	
CBO	-4	-12	-13	0	0	
Difference	-4	-32	13	0	0	
Corrected Wage Index						
OMB	0	0	0	0	0	
CBO	11	0	0	0	0	
Difference	-11	0	0	0	0	
Disabled Buy-In						
OMB	0	0	0	0	0	
CBO	0	-2	-7	-12	-18	
Difference	0	-2	-7	-12	-18	
Interactive Effect on HI Premiums (7)						
OMB	-41	8 ^r	-61	-28	-5	
CBO	0	0	0	0	0	
Difference	-41	8 ^r	-61	-28	-5	
1.42% Hospital Increase						
OMB	525	-110	0	0	0	
CBO	525	110	0	0	0	
Difference	0	0	0	0	0	

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OMB-CBO Pricing Comparison - Detail

CERA 89 Part A

	1990	1991	1992	1993	1994
Part A Sequester					
OMB	795	110	0	0	0
CBO	805	110	0	0	0
Difference	-10	0	0	0	0
HMO Addback					
OMB	-35	-8	0	0	0
CBO	-35	-8	0	0	0
Difference	0	0	0	0	0
Home Health Limits					
OMB	-10	-20	0	0	0
CBO	0	0	0	0	0
Difference	-10	-20	0	0	0
Religious Orders					
OMB	0	0	0	0	0 • Baseline issue in scoring. OMB doesn't score on appropriated amounts.
CBO	-12	15	-20	0	
Difference	12	15	-20	0	
Secondary Payor Info from IRS					
OMB	20	240	430	610	660 • Longer OMB phase-in
CBO	325	780	680	420	110 • CBO believed in 550 behavioral shift, leading to
Difference	-305	-540	-250	190	
Hospital-based Nursing Schools					
OMB	0	0	0	0	0 • Baseline phase-out. OMB doesn't score on appropriated amounts.
CBO	-35	0	0	0	
Difference	35	0	0	0	
CNA's (SMI to HI Transfer)					
OMB	0	0	0	0	0 • Baseline issue in scoring. OMB doesn't score on appropriated amounts.
CBO	35	0	0	0	
Difference	35	0	0	0	
Total OMB	559	-253	-231	-63	-55
Total CBO	734	164	-144	-397	-744
Total Difference	-175	-417	-87	334	384
Total HI Expenditures	65722	68897	76186	83250	92102
Difference as % of Total	-0.21%	-0.61%	-0.11%	0.40%	0.75%
					0.10%



ISBN 0-16-041711-2



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